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SUPREME COURT OF THE STATE OF NEW YORK
COUNTY OF NEW YORK

AMBAC ASSURANCE CORPORATION,	:	Index No. 650421/2011
Plaintiff,	:	Hon. Charles E. Ramos
- against -	:	
EMC MORTGAGE LLC (formerly known as EMC MORTGAGE CORPORATION), J.P. MORGAN SECURITIES LLC, (formerly known as BEAR, STEARNS & CO. INC.), and JPMORGAN CHASE BANK, N.A.,	:	**FIRST AMENDED COMPLAINT**
Defendants.	:	

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Plaintiff Ambac Assurance Corporation ("Ambac"), by and through its attorneys, Patterson Belknap Webb & Tyler LLP, for its complaint against defendants EMC Mortgage LLC, formerly known as EMC Mortgage Corporation ("EMC"), Bear Stearns & Co. Inc. ("Bear, Stearns & Co.," together with EMC, "Bear Stearns" and now doing business as J.P. Morgan Securities LLC ("JP Morgan")), and JPMorgan Chase Bank, N.A. ("JPMC Bank") hereby alleges upon personal knowledge as to itself and as to its own conduct and upon information and belief as to all other matters, as follows:

NATURE OF THE ACTION

1. In mid-2006, Bear Stearns induced investors to purchase, and Ambac as a financial guarantor to insure, securities that were backed by a pool of mortgage loans that – in the words of the Bear Stearns deal manager – was a "SACK OF SHIT."[1] Within the walls of its sparkling new office tower, Bear Stearns executives knew this derogatory and distasteful characterization aptly described the transaction. Indeed, Bear Stearns had deliberately and secretly altered its policies and neglected its controls to increase the volume of mortgage loans available for its "securitizations" made in patent disregard for the borrowers' ability to repay those loans. After the market collapse exposed its scheme to sell defective loans to investors through these transactions, JP Morgan executives assumed control over Bear Stearns and implemented an across-the-board strategy to improperly bar EMC from honoring its contractual promises to disclose and repurchase defective loans through a series of deceptive practices. In what amounts to accounting fraud, JP Morgan's bad-faith strategy was designed to avoid and has avoided recognition of the vast off-balance sheet exposure relating to its contractual repurchase

[1] Email from Nicholas Smith (Bear, Stearns & Co. Vice President and Deal Manager) to Keith Lind (Bear, Stearns & Co. Managing Director, Trading), dated August 11, 2006, EMC-AMB 004377399-400 (referring to SACO 2006-8 Transaction as a "SACK OF SHIT [2006-]8" and stating "I hope your [sic] making a lot of money off of this trade.").

obligations – thereby enabling JPMorgan Chase & Co. to manipulate its accounting reserves and allowing its senior executives to continue to reap tens of millions of dollars in compensation following the taxpayer-financed acquisition of Bear Stearns.

2. The securitization transactions at issue here involved the sale by EMC of pools of mortgage loans to trusts, which in turn issued to investors securities that were to be paid down by the promised cash flows from the mortgage loans. As the underwriter and deal manager for the securitizations, Bear, Stearns & Co. solicited rating agencies such as Standard & Poor's and Moody's to rate, bond insurers like Ambac to insure, and investors to purchase the mortgage-backed securities. Bear, Stearns & Co. and EMC acted in concert – under the common control of their parent The Bear Stearns Companies, Inc. – to dupe Ambac and investors to participate in their securitizations. (Thus, Bear, Stearns & Co. and EMC are referred together herein as "Bear Stearns" unless clarification is required.)

3. Specifically, this action arises from Bear Stearns' fraudulent inducement of Ambac and investors to participate in four securitizations, and EMC's extraordinary and material breach of the unambiguous terms and fundamental premise of its agreements governing those transactions, executed between December 2005 and April 2007: the SACO I Trust Series ("SACO") 2005-10, 2006-2, and 2006-8 Transactions, and the Bear Stearns Second Lien Trust ("BSSLT") 2007-1 Transaction (collectively, the "Transactions").

4. In order to induce Ambac's participation, Bear Stearns made representations to Ambac *in advance of the closing* of the Transactions regarding, among other things, (i) the "due diligence" purportedly conducted to prevent defective mortgage loans from entering the securitizations, (ii) the "quality control" processes purportedly implemented to weed out the aberrant defective loan that slipped through the diligence into the securitized pools, (iii) the

protocols Bear Stearns purportedly would follow to "repurchase" any defective loan from the securitizations, and (iv) the "seller monitoring" protocols Bear Stearns purportedly followed to prevent the securitization of loans from suppliers of bad loans. In the parties' agreements *executed in connection with closing*, EMC then made numerous express contractual representations and warranties concerning key attributes of the mortgage loans that backed the securities and the practices of the entities that made those loans, including that the loans were *not* originated through improper means (*e.g.*, fraud or underwriter negligence). EMC also contractually agreed to (a) provide "prompt" notification to Ambac and other deal participants of any loan found to breach its representations and warranties, (b) cure, repurchase, or provide adequate substitutes for breaching loans within 90 days thereafter, and (c) indemnify and reimburse Ambac for any losses caused by such breaches.

5. Bear Stearns knew full well that these representations, going to the very premise of the securitizations, were false and misleading when made. Recently obtained disclosures from Bear Stearns' files have revealed that it secretly adopted certain practices and policies, and abandoned others, to (i) increase its transaction volume by quickly securitizing defective loans before they defaulted, (ii) conceal from Ambac and others the defective loans so it could keep churning out its securitizations, (iii) obtain a double-recovery on the defective loans it securitized, (iv) disregard its obligations to repurchase defective loans, and (v) profit on Ambac's harm.

6. More specifically, Bear Stearns intentionally implemented certain "due diligence" protocols and rejected others to allow it to securitize loans made to borrowers with no ability to repay their loans. To start, Bear Stearns utilized due diligence firms to re-underwrite loans for its securitizations that *it knew* were not screening out loans that were defective and likely to default.

As Bear, Stearns & Co. Senior Managing Director Jeffrey Verschleiser stated in no uncertain terms to fellow Senior Managing Director Michael Nierenberg in March 2006, "[we] are wasting way too much money on Bad Due Diligence."[2] Almost exactly one year later nothing had changed, and in March 2007, Verschleiser reiterated with respect to the *same* due diligence firm that "[w]e are just burning money hiring them."[3] Despite this recognition, Bear Stearns did not change firms or enhance the diligence protocols. Thus, as one of its due diligence consultants frankly admitted, "the vast majority of the time the loans that were rejected were still put in the pool and sold."[4]

7. Moreover, even while criticizing its due diligence firms for failing to adequately detect defective loans, Bear Stearns routinely *overrode* those conclusions and went ahead and purchased and securitized those loans despite material defects that Bear Stearns knew of but failed to disclose (up to ***65% of the time in the third quarter of 2006*** according to one firm's report).[5] Bear Stearns ignored the proposals made by the head of its due diligence department in May 2005 to track the override decisions, and instead took the opposite tack, adopting an internal policy that directed its due diligence managers to delete the communications with its due diligence firms leading to its final loan purchase decisions, thereby eliminating the audit trail.[6] Further still, Bear Stearns elected *not* to implement "significant" changes to its due diligence

[2] Email from Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director) to Michael Nierenberg (Bear, Stearns & Co. Senior Managing Director), among others, dated March 23, 2006, EMC-AMB 001542438-439.

[3] Email from Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director) to Michael Nierenberg (Bear, Stearns & Co. Senior Managing Director), among others, dated March 15, 2007, EMC-AMB 005446200.

[4] 8/28/2010 Warren Deposition Tr. at 46. *See* Section III.C.1, below.

[5] Internal Report produced by Clayton Holdings, Inc., CLAY-AMBAC 0001770-80 at 1777 (showing a 65% override rate for EMC and 56% override rate for Bear Stearns in the third quarter of 2006).

[6] 4/21/2010 Mongelluzzo Deposition Tr. at 167-76; 2/3/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 318-19.

protocols designed to detect and reject risky loans.[7] In March 2007, for example, the same head of due diligence made a proposal "to completely revamp how we do due diligence," which he conceded was the *same* general proposal he made in May 2005, *but that was never implemented.*[8] This was not happenstance. Bear Stearns disregarded loan quality to appease its trading desk's ever-increasing demand for loans to securitize. In fact, Bear, Stearns & Co. Senior Managing Director Mary Haggerty issued a directive in early 2005 to *reduce* the due diligence "in order to make us more competitive on bids with larger sub-prime sellers."[9]

8. In full recognition that its due diligence protocols did not screen out defective loans and were merely a facade maintained for marketing purposes, Bear Stearns' trading desk needed to quickly transfer the toxic loans from its inventory and into securitizations before the loans defaulted. So as early as 2005, Bear Stearns quietly revised its protocols to allow it to securitize loans before the expiration of the thirty- to ninety-day period following the acquisition of the loans by EMC, referred to as the "early payment default" or "EPD" period. Bear Stearns previously held loans in inventory during the EPD period because, as Bear, Stearns & Co.'s Managing Director Baron Silverstein acknowledged, loans that miss a payment shortly after the loan origination (*i.e.*, within the EPD period) raise "red flags" that the loans never should have been issued in the first instance.[10] The revised policy enhanced Bear Stearns' earnings by increasing the volume of loans it sold into the securitizations – but materially increased the

[7] 6/4/2010 Silverstein Deposition Tr. at 178.

[8] Email from John Mongelluzzo (Bear, Stearns & Co. Vice President of Due Diligence) to Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finance) and Baron Silverstein (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finance), among others, dated March 6, 2007, EMC-AMB 001431086.

[9] Email from John Mongelluzzo (Bear, Stearns & Co. Vice President of Due Diligence) conveying instructions from Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finance) to reduce due diligence, dated February 11, 2005, EMC-AMB 001718713-14.

[10] 6/4/2010 Silverstein Deposition Tr. at 192.

riskiness of loans sold to the securitizations. Nonetheless, as its executives uniformly conceded, Bear Stearns never once disclosed the changes in its due diligence and securitization policies to investors or financial guarantors such as Ambac.[11]

9. And it gets worse. Not satisfied with the increased fees from the securitizations, Bear Stearns executed a scheme to double its recovery on the defective loans. Thus, when the defective loans it purchased and then sold into securitizations stopped performing during the EPD period, Bear Stearns confidentially (i) made claims against the suppliers from which it purchased the loans (*i.e.*, the "originators" of those loans) for the amount due on the loans, (ii) settled the claims at deep discounts, (iii) pocketed the recoveries, and (iv) left the defective loans in the securitizations. Bear Stearns did not tell the originators of the loans that it did not own, but rather had securitized, the loans as to which it made the claims, and did not tell the securitization participants that it made and settled claims against the suppliers. Nor did it review the loans for breaches of EMC's representations and warranties in response to the "red flags" raised by the EPDs. Bear Stearns thus profited doubly on defective loans it sold into securitizations. Indeed, the increase in loan volume from the securitization of defective loans proved so substantial, and the recoveries secured on those defective loans proved so lucrative that, by the end of 2005, the Bear Stearns' trading desk mandated that all loans were to be securitized before the EPD period expired.[12]

10. Bear Stearns also concealed that its "quality control" and "repurchase" processes were *not* devoted to flushing out and removing breaching loans from the securitized pools, as

[11] *See* Section III.C.2, below.

[12] Email from Chris Scott (Bear, Stearns & Co. Senior Managing Director, Trading) to, among others, Robert Durden (Bear, Stearns & Co. Deal Manager) and Keith Lind (Bear, Stearns & Co. Managing Director, Trading), dated January 3, 2006, EMC-AMB 001385832-833; 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 272-73.

Bear Stearns had represented. Rather, the processes were dedicated to securing recoveries against the suppliers of its toxic loans. That is, the quality control and repurchase departments' resources were focused virtually exclusively on (i) identifying grounds for Bear Stearns to make claims against the suppliers of the loans it securitized, and (ii) settling the claims at a discount – without ever notifying the securitization participants of the defective loans it identified or the funds it received. In other words, the quality control department that Bear Stearns touted to Ambac and investors did not provide them with the represented benefits.

11. The secret settlement of the claims on the securitized loans was a win-win for Bear Stearns and its suppliers, but a loss for the securitizations. It was a win for the suppliers in that they settled in confidence all claims with respect to the defective loans at a fraction of the full amount that would have been due had the loans been repurchased from the securitization. Conversely, if they did not comply with Bear Stearns' repurchase demands, Bear Stearns cut off the financing it extended for the origination of additional defective loans.[13] The secret settlement was a win for Bear Stearns, which (i) reinforced its relations with the suppliers that it depended on to provide the precious fodder for future securitizations by settling at the discounted amount, and (ii) pocketed the recovery from the suppliers. It was a loss to the securitization participants, which were not notified of the defective loans in the securitizations and did not receive the benefit from the repurchase of defective loans from the securitizations. Indeed, having settled with originators at a fraction of the outstanding principal and interest due on the loans, Bear

[13] Bear Stearns extended financing to its suppliers that it knew – from its due diligence and quality control processes – were originating defective loans, but cut-off that financing if the supplier defaulted on its settlement agreement with Bear Stearns. *See* Letter from Stephen Golden (EMC Residential Mortgage Corp. President) to SouthStar Funding LLC, dated April 9, 2007, EMC-AMCB1 57571-72; Email from Paul Friedman (Bear, Stearns & Co. Senior Managing Director, Fixed Income) to Jeffrey Mayer (Bear, Stearns & Co. Senior Managing Director and Co-Head of Fixed Income), dated April 18, 2007, EMC-AMB 012043282-283. By agreeing to finance and purchase loans from suppliers of defective loans, Bear Stearns effectively engaged in the origination of defective loans.

Stearns had an economic ***disincentive*** to honor its securitization obligations to identify and repurchase breaching loans from the trusts at the full outstanding amounts due.

12. Ironically, Bear Stearns' scheme worked so well – and resulted in the securitization of so many loans made to borrowers that could not repay – that its quality control and repurchase processes were soon overwhelmed.[14] By late 2005, Bear Stearns' internal audit department caught wind of the "significant backlog for collecting from and submitting claims to sellers," which it then tracked from October 2005 through January 2007.[15] Yet Bear Stearns did not disclose that its lauded repurchase protocols were overwhelmed and were not providing any benefit to the securitizations, and that it was not evaluating whether the defective loans it identified complied with EMC's representations and warranties to the securitization participants.

13. By mid-2006, Bear Stearns' repurchase claims against the suppliers of the loans had risen to alarming levels, prompting warnings from its external auditors and counsel. In a report dated August 31, 2006, the audit firm PriceWaterhouseCoopers advised Bear Stearns that its failure to promptly evaluate whether the defaulting loans breached EMC's representations and warranties to the securitization participants was contrary to "common industry practices, the expectation of investors and . . . the provisions in the [deal documents]."[16] Shortly thereafter, Bear Stearns' internal counsel advised Bear Stearns' management that it was breaching its contractual obligations by failing to contribute to the securitizations the proceeds it recovered

[14] 4/26/2010 Golden Deposition Tr. at 119; *see* Section III.C.4, below.

[15] Bear Stearns Internal Audit Report, dated February 28, 2006, EMC-AMB 001496305-11 at p. 2; *see* Section III.C.4, below.

[16] *See* "UPB Break Repurchase Project – August 31, 2006," EMC-AMB 006803201-77 at 233

pertaining to the loans in the securitizations.[17] Bear Stearns did not disclose to Ambac either of the findings.

14. Instead of making the requisite disclosures and undertaking the appropriate cures, thereafter Bear Stearns implemented measures to obscure the magnitude of defective loans in its securitizations, and maintain its flow of loans from the suppliers of the defective loans. Thus, Bear Stearns quickly moved to reduce the outstanding claims – to the detriment of the securitizations – by (i) settling the claims at a fraction of the dollar, (ii) waiving the claims entirely, or (iii) deferring (and potentially voiding) the claims by extending the EPD period for securitized loans that defaulted during the initial EPD period, but then resumed payments.[18] Demonstrating the impropriety of its measures, Bear Stearns explicitly directed its employees *not* to extend the EPD period for loans in Bear Stearns' inventory, *i.e.*, not to apply the same rule for loans in its own inventory that it secretly adopted for the securitized loans. According to its Senior Managing Director, Bear Stearns adopted this dual standard because it knew loans that experienced an initial EPD were likely to default again and the "trading desk didn't want to own loans in inventory that had an EPD."[19] Bear Stearns' undisclosed policy thus imposed a risk on the securitizations that its own trading desk would not accept.

15. As a result of these covert measures, Bear Stearns was able to quickly address the backlog of claims, without disclosing or analyzing whether the loans on which it submitted claims breached EMC's representations and warranties to the securitizations. By January 2007, the Bear Stearns internal audit department reported that in 2006 it had resolved "$1.7 billion of

[17] *See* 2/3/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 456-57; 4/26/2010 Golden Deposition Tr. at 39-40.

[18] *See* Section III.C.6, below.

[19] 4/26/2010 Golden Deposition Tr. at 152-53.

claims, an increase of over 227% from the previous year," and that "$2.5 billion in claims were filed, reflecting an increase of 78% from the prior year."[20] The "majority" of the claims pertained to loans with EPDs, *i.e.*, the loans that Bear Stearns acquired without conducting the represented due diligence and conveyed to the securitizations before they defaulted.[21]

16. Bear Stearns followed the same surreptitious practices with respect to the loans in the Transactions. In the disclosures secured to date, Bear Stearns' internal data reveals that it made claims against originators for almost 4,000 loans in the Transactions (with an aggregate original principal balance of $272.7 million) – but repurchased just 237 of those loans from the Transactions.[22] The majority of Bear Stearns claims' were made in 2006 during the height of its double-recovery scheme. The claims then dropped off dramatically in 2007 after Bear Stearns was advised by counsel that it had to relinquish any recoveries on the securitized loans to the Transactions. The claims spiked again in 2009, when as discussed below, JP Morgan began asserting repurchase demands to originators for the breaching loans that Ambac demanded that EMC repurchase – but that Bear Stearns refused to repurchase – from the Transactions. Bear Stearns never gave notice to Ambac or the other Transaction participants of the large-scale defective loans that Bear Stearns itself identified from 2005 through 2007.

17. Yet the magnitude of the defective loans aggregated for its securitizations was starkly evident to the "deal managers" responsible for disclosing the material information concerning the Transactions to potential participants. Thus, the Bear Stearns Vice President who acted as the deal manager for the SACO 2006-8 Transaction referred to the deal in

[20] Bear Stearns Internal Audit Department Escalation Memorandum, dated February 26, 2007, EMC-AMB 010858610-613 at 611.

[21] 4/26/2010 Golden Deposition Tr. at 120-21.

[22] Whole Loan Inventory Tracking System ("WITS") Database, EMC-AMB 002768454; LMS Database, EMC-AMB1 000007558.

correspondence with the trading desk as a "shit breather" and a "SACK OF SHIT."[23] Needless to say, Bear Stearns neglected to mention to Ambac or investors its internal assessments and derogatory characterizations, and did not terminate its securitization.

18. Bear Stearns elected instead to continue to mischaracterize and securitize. Indeed, in early 2007, Bear Stearns publicly purported to "tighten" standards (to adopt policies that should have been in place all along) to buy time while it attempted to clear out its inventory of defective loans. For example, Bear Stearns downgraded certain suppliers of its loans to "suspended" or "terminated" status pursuant to its touted "seller monitoring" protocols, but then directed its quality control personnel ***to stop conducting reviews of those originators' loans*** so it could move the loans out of its inventory and into its securitizations.[24] And, if these loans were not securitized and left in Bear Stearns' inventory, the traders went on tirades, demanding "to know why we are taking losses on 2nd lien loans from 2005 when they could have been securitized?????"[25] Indeed, simultaneous with its hard sell to Ambac regarding its purported efforts to improve underwriting standards of the loans in the BSSLT 2007-1 Transaction executed in April 2007, the Bear Stearns analyst working on the deal more accurately described the deal in internal correspondence as a "going out of business sale."[26] Another called it a

[23] Remarkably, when his counsel attempted to elicit testimony to explain away these egregious characterizations, the best the Vice President could say is that "shit breather" was a "term of endearment." 6/2/2010 Smith Deposition Tr. at 211-12.

[24] 5/20/2010 Serrano Deposition Tr. at 180-184 (testifying that, over his objections, the President of EMC Residential Corporation, and others, directed the quality control department to stop the review of the suspended and terminated sellers).

[25] Email from Keith Lind (Bear, Stearns & Co. Managing Director, Trading) to Baron Silverstein (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finance), among others, dated May 8, 2007, EMC-AMB 002283474-476.

[26] Email from Charles Mehl (Bear, Stearns & Co. Analyst, Mortgage Finance) to Keith Lind (Bear, Stearns & Co. Managing Director, Trading), dated April 5, 2007, EMC-AMB 002075468.

"DOG".[27] Both were accurate, yet undisclosed, internal perspectives. Indeed, one of the largest sources of loans in the BSSLT 2007-1 Transaction was SouthStar Funding LLC, an originator that Bear Stearns suspended before the Transaction closed, but stopped its quality control review on those loans so it could move them into the deal and off Bear Stearns' books.

19. Bear Stearns' material misrepresentations and omissions, and false contractual representations and warranties, induced investors to purchase and Ambac to insure securities issued in the Transactions from December 2005 to April 2007.

20. What happened next is now well known: With real estate prices in decline, Bear Stearns and other lenders no longer could extend additional financing to borrowers with no ability to pay so that borrowers could flip their properties to pay off their loans or refinance their loans before they defaulted. The loans that never should have been issued and securitized thus began to default in record numbers. As a result, in the latter part of 2007, the public saw the beginnings of the crisis unfold.

21. In addition to the recently-revealed internal policies and practices that precipitated the Transactions, what was not known until recently was Bear Stearns' (and thereafter JP Morgan's) deliberate misconduct to conceal and avoid accountability for their fraudulent conduct and contractual commitments after the Transactions closed. To start, in late 2007, as the rating agencies began to adjust their ratings of Bear Stearns' mortgage-backed securities, Bear Stearns senior executives – including Senior Managing Director Thomas Marano – attempted to prop up those ratings with threats to withhold "every fee" due to the rating agencies that downgraded the

[27] Email from John Tokarczyk (Bear, Stearns & Co. Associate Director) to Jeffrey Maggard (Bear, Stearns & Co. Managing Director and Deal Manager on the BSSLT 2007-1 Transaction), dated April 30, 2007, EMC-AMB 001469603-604 ("LETS CLOSE THIS DOG").

Bear Stearns securities.[28] Bear Stearns then implemented a policy to conceal the defective loans it identified and thwart the repurchase demands made by Ambac and other securitization participants upon discovery of breaches of EMC's representations and warranties.

22. Despite being advised by its outside auditors and counsel in mid-2006 to review the defective loans it identified for breaches of EMC's representations and warranties, it was not until late 2007, when it could no longer stifle the concern regarding its securities, that Bear Stearns adopted a policy to undertake such review. The belated implementation prompted Bear, Stearns & Co.'s Quality Control Director to note that EMC was for the first time "fully honoring [its] obligations to pro-actively review defective loans for potential PSA [or, securitization] breach."[29] But EMC did *not* thereafter comply with its obligations to provide notice of the breaches it identified, despite direct inquiries and proffers made by Ambac and other securitization participants.

23. By late 2007, Ambac began observing initial signs of performance deterioration in the Transactions, and requested from EMC the loan files for 695 non-performing loans, which were drawn from the three SACO Transactions. When Ambac reviewed the loan files that EMC eventually provided, it discovered widespread breaches of EMC's representations and warranties. Almost 80% of the loans examined, with an aggregate principal balance of approximately $40.8 million across all the Transactions, contained breaches of EMC's

[28] Email from Thomas Marano (Bear, Stearns & Co. Senior Managing Director) to Baron Silverstein (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finance), among others, dated October 17, 2007, EMC-AMB 001424910-911.

[29] Email from Leslie Rodriguez (EMC Residential Corporation Managing Director) to Whitney Long (EMC Residential Mortgage, Vice President of Risk Management and Claims), dated September 14, 2007, EMC-AMB 006870106-110 at 108. *See also* Email from Fernando Serrano (EMC Mortgage Corporation, Quality Control Manager), dated September 12, 2007 attaching EMC Securitization Breach Quality Control Review protocol, EMC-AMB 011688246-249 at 248 ("Effective in September 2007, all Quality Control Channels . . . are providing to the Securitization Breach team a monthly reporting of all defective loans. This will ensure that going forward all defective loans are reviewed for a securitization breach concurrent with the QC review.").

representations and warranties. Unbeknownst to Ambac until recently, Bear Stearns engaged a consultant to preemptively review the same loan files Ambac requested in late 2007. After an iterative review process between Bear Stearns and its consulting firm to whittle down the breach rate, they still concluded that ***56% of the loans*** were defective.[30] In breach of its clear contractual obligations, EMC did not advise Ambac of its conclusions or provide Ambac or any other securitization participant with "prompt notice" of the breaches identified as it was required to do.

24. Knowing that its fraudulent and breaching conduct was resulting and would continue to result in grave harm to Ambac, Bear Stearns then implemented a trading strategy to profit from Ambac's potential demise by "shorting" banks with large exposure to Ambac-insured securities. (The "shorts" were bets the banks' shares or holdings would decrease in value as Ambac incurred additional harm.) In late 2007, Bear, Stearns & Co. Senior Managing Director Jeffrey Verschleiser boasted that "[a]t the end of October, while presenting to the risk committee on our business I told them that a ***few financial guarantors were vulnerable*** to potential write downs in the CDO and MBS market and ***we should be short*** a multiple of 10 of the shorts I had put on . . . In less than three weeks we made approximately $55 million on just these two trades."[31] Bolstered by this success, Bear Stearns carried this trading strategy into 2008. On February 17, 2008, a Bear Stearns trader told colleagues and Verschleiser, "***I am positive fgic is done and ambac is not far behind***."[32] The next day, in the same email chain, the trader again wrote to Verschleiser to clarify which banks had large exposures to Ambac, asking "***who else***

[30] Loan Disposition Summary (AMB0710) prepared by Clayton Services, Inc. for Bear Stearns, dated November 16, 2007, CLAY-AMBAC 019669.

[31] Email from Verschleiser, dated November 20, 2007, EMC-AMB 009600760-63.

[32] Email from Adam Siegel (Bear Stearns & Co. Senior Managing Director, ABS/MBS Credit Trading), dated February 17, 2008, EMC-AMB 012117052-063.

has big fgic or abk [Ambac] exposures besides soc gen?"[33] As it was "shorting" the banks holding Ambac-insured securities, Bear Stearns continued to conceal the defects it discovered and deny Ambac's repurchase demands relating to collateral that back the securities issued in the Transaction.

25. The senior management of Bear Stearns allowed the foregoing misconduct to occur, and failed to implement the controls required to prevent such abuses, because they were making tens of millions of dollars churning out securitizations replete with loans that never should have been made, and that were only made because Bear Stearns provided the means to convert those loans into securities for sale to investors. Because Bear Stearns was a public company, and they were "playing with other people's money," the Bear Stearns executives disregarded the long-term implications of their conduct to generate the short-term earnings that funded their extraordinary compensation packages. This textbook example of unmitigated and realized "moral hazard" risk has wreaked unprecedented harm on (i) the borrowers that have defaulted in droves and lost their homes because they were put into loans they could not afford, (ii) the investors that purchased the securities issued in the Bear Stearns transactions, (iii) Ambac as a financial guarantor of the payments due to the investors, (iv) Bear Stearns' own shareholders, and (v) the national, and indeed global, economy. The senior management of JP Morgan made matters even worse when, in early 2008, they assumed control of EMC and Bear, Stearns, & Co.

26. With EMC's liabilities now consolidated into the JPMorgan Chase & Co. financials, JP Morgan implemented a bad-faith strategy to deny Ambac's legitimate repurchase demands to EMC – even in those instances where JP Morgan concluded that EMC would be

[33] Email from Adam Siegel (Bear Stearns & Co. Senior Managing Director, ABS/MBS Credit Trading), to Verschleiser, among others, dated February 18, 2008, EMC-AMB 012117048-051.

liable for breach of contract. JP Morgan caused EMC to reject legitimate repurchase demands by Ambac, as well as other financial guaranty insurers, to understate materially the accounting reserves JPMorgan Chase & Co. was required to accrue and disclose in its financial statements to reflect the liability inherited from EMC for repurchase obligations associated with defective loans. JP Morgan thus interfered with EMC's contractual obligations to Ambac (and other insurers) to assist its parent corporation, JP Morgan Chase, effectuate a massive accounting fraud. JP Morgan interfered fraudulently, and deceptively represented to Ambac that the rejections of Ambac's repurchase demands were based on the reasons set forth in the written responses to the demands. In fact, JP Morgan itself had concluded, and knew that EMC and Bear Stearns & Co. (prior to JP Morgan taking control of Bear Stearns & Co.) previously had concluded, that the bases for the repurchase demands for a substantial portion of challenged loans were well founded. Indeed, in a number of instances, EMC had made repurchase demands on the originators of the loans for the very same reason(s) Ambac cited in support of its repurchase demands to EMC.

27. Thus, *within just days* of assuming control of Bear Stearns' repurchase review process, a JP Morgan Executive Director, with no prior knowledge of the deals, arbitrarily rejected half of Bear Stearns' affirmative breach findings that included several loans from the Transactions, and in one stroke eliminated up to $14 million in liabilities, thereby achieving the intended purpose of reducing the accounting reserves for those loans by almost 50%.[34] In addition, with respect to the loans that Ambac requested EMC to repurchase in April and May 2008 (*see supra* ¶ 23), JP Morgan executives deliberately disregarded that Bear Stearns itself had

[34] Email from Whitney Long (EMC Residential Mortgage, Vice President of Risk Management and Claims) to Alison Malkin (J.P. Morgan Securities, Inc. Executive Director, Securitized Products), who was responsible for the "re-review" of Bear Stearns prior breach designations, dated May 05, 2008, EMC-AMB 007173918-919.

identified widespread breaches ***in the very same loan sample*** in its covert review undertaken in late 2007 before JP Morgan's interference. Instead, responding on behalf of EMC, JP Morgan rejected virtually every one of the 526 loans that Ambac identified as being in breach.[35]

27. Moreover, even while refusing to repurchase breaching loans that Ambac identified and requested, the same JP Morgan executive implemented a policy of demanding that suppliers repurchase *from* EMC the *same* loans, for the *same* reasons that Ambac and other financial guarantors had requested EMC to repurchase.[36] JP Morgan rebuffed Ambac's repurchase requests even where Bear Stearns had previously demanded that originators repurchase the exact same loans because the same or similar defects subsequently identified by Ambac.[37] The duplicitous and deceptive conduct is patent and the motivation clear: JP Morgan adopted a strategy to deliberately and systematically deny the financial guarantors' legitimate repurchase demands to avoid JPMorgan Chase & Co. from bringing onto its financial statements the massive off-balance sheet exposure and, in doing so, effectively engaged in accounting fraud.

28. Ambac's on-going analyses of the loans in the Transactions have affirmed JP Morgan's malfeasance, and Bear Stearns' internal derogatory characterization of the loan pools leading up to the Transactions. After conducting the initial review noted above, Ambac reviewed a random sample of 1,482 loans, with an aggregate principal balance of approximately $88.2 million, selected across all four Transactions. The results of that review are remarkable. Of these 1,482 loans, 1,351, or over 91%, breached one or more of the representations and warranties that EMC had made to Ambac. As of June 2010, Ambac's loan-level review consisted of 6,309 loans, of which it identified 5,724 loans across the Transactions that breached

[35] EMC "agreed" to repurchase just nine loans out of the sample reviewed, but has not done so.

[36] *See* Section III.F, below.

[37] *Id.*

one or more of EMC's representations and warranties. Bear Stearns (now JP Morgan) – acting with authority to perform EMC's obligations under the Transactions – has to date "agreed" to repurchase only 52 loans, or less than 1%, of those breaching loans, but has in fact not repurchased a single one.[38]

29. The most prevalent breaches identified by Ambac are also the most troubling and involve: (i) rampant misrepresentations about borrower income, employment, assets, and intentions to occupy the purchased properties, and (ii) the loan originators' abject failures to adhere to proper and prudent mortgage-lending practices, including their own underwriting guidelines. The pervasiveness of these breaches has subsequently been confirmed by EMC's recent disclosures of its internal quality control and claims documentation and data, as well as the dramatic testimony of the borrowers of those loans.[39]

30. Loss and delinquency patterns experienced by the Transactions have also been consistent with these revelations. The loans that Bear Stearns securitized have defaulted at an extraordinary rate, depriving the Transactions of the cash flows required to pay down the respective securities and, thereby, requiring Ambac to make enormous payments with respect to its insurance policies. The four Transactions have together suffered more than $1.2 billion in losses, resulting in more than $641 million in total claims paid by Ambac.

31. Bear Stearns' material misrepresentations, omissions and breaches of the parties' agreements fundamentally altered and essentially gutted the parties' bargain, the nature of the Transactions, and the value of and interests in the securitized loans. Bear Stearns has thereby inflicted and is inflicting tremendous harm on Ambac and the investors Ambac insures. Ambac

[38] *See* Section VI.A, below.

[39] *See* Sections VI.B, & C, respectively, below.

is therefore entitled to be made whole and to be placed in the position that it would have been in had it never entered into any of the Transactions.

I. THE PARTIES

A. PLAINTIFF

32. Ambac is a Wisconsin corporation with its principal place of business at One State Street Plaza, New York, New York 10004. Based in large part on the economic harm it has suffered as a result of Defendants' misconduct, Ambac has been involved in rehabilitation proceedings under Wisconsin insurance law. In connection with those proceedings, on March 24, 2010, Ambac established a segregated account (the "Segregated Account") pursuant to Wisconsin Statute Section 611.24, with the approval of the Office of the Commissioner of Insurance of the State of Wisconsin (the "Commissioner"). On the same date and upon the Verified Petition of the Commissioner, the Circuit Court for Dane County, Wisconsin, placed the Segregated Account into statutory rehabilitation under Wisconsin Statute Sections 645.31 and 645.32 on March 24, 2010. Ambac allocated the policies at issue in this action to the Segregated Account pursuant to the Plan of Operation for the Segregated Account.

B. THE "BEAR STEARNS" DEFENDANTS

33. EMC is organized under the laws of the State of Delaware and its principal place of business is at 2780 Lake Vista Drive, Lewisville, Texas 75067. At all relevant times leading up to, and including, when the Transactions were effectuated, EMC was a wholly owned subsidiary corporation of The Bear Stearns Companies Inc. ("The Bear Stearns Companies") and an affiliate of the depositor and underwriter in the Transactions. Pursuant to a merger agreement effective May 30, 2008, JPMorgan Chase & Co. acquired the assets and operations of The Bear Stearns Companies Inc., including Bear, Stearns & Co. and EMC, for nominal consideration in a transaction that was financed in part by a $29 billion non-recourse loan made by taxpayers (the

"Merger"). After the Merger, EMC is wholly owned by The Bear Stearns Companies, LLC, which in turn is wholly owned by JPMorgan Chase & Co.[40] On or about March 31, 2011, EMC underwent a change in form from a corporation to a limited liability company, and it now is registered in Delaware as EMC Mortgage LLC.

34. Bear, Stearns & Co. was an SEC-registered broker-dealer and a wholly-owned subsidiary of The Bear Stearns Companies Inc., principally located at 383 Madison Avenue, New York, NY 10179. Bear, Stearns & Co. served as the underwriter for all of the Transactions. Following the Merger, on or about October 1, 2008, Bear, Stearns & Co. merged with an existing subsidiary of JPMorgan Chase & Co. known as J.P. Morgan Securities Inc., and the resulting entity is now doing business as J.P. Morgan Securities Inc. Effective September 1, 2010, JP Morgan Securities Inc. converted from a corporation to a limited liability company, and changed its name to J.P. Morgan Securities LLC (defined above as "JP Morgan"). Accordingly, all allegations against Bear, Stearns & Co. are made against its legal successor, JP Morgan.

35. JP Morgan is a wholly owned subsidiary of JPMorgan Chase & Co., which is an investment banking holding company incorporated in Delaware and principally located at 270 Park Avenue, New York, NY, 10016.

36. JPMC Bank is a national banking association whose articles of association designate Columbus, Ohio as the location of its main office, and whose principal place of business is in New York, New York. JPMC Bank acquired all or substantially all of EMC's assets and succeeded to EMC's business on or about April 1, 2011. JPMC Bank and EMC are both wholly owned by JPMorgan Chase & Co. JPMC Bank and EMC are affiliated entities that shared common ownership before the Asset Transfer and continue to share common ownership

[40] EMC's 7.1 Disclosure Statement filed January 20, 2009.

after the Asset Transfer. As explained more fully below, JPMC Bank is a successor to EMC and is therefore liable for the conduct of EMC alleged herein.

II. JURISDICTION, VENUE AND PRIOR PROCEEDINGS

37. This Court has personal jurisdiction over the defendants pursuant to N.Y. C.P.L.R. §§ 301, 302, 311, and 311-a.

38. Venue is proper in New York County pursuant to N.Y. C.P.L.R. §§ 503(a), 503(c), and 503(d).

39. Further, in its Insurance and Indemnity Agreement ("I&I Agreement") with Ambac for each Transaction, EMC irrevocably submitted to the "non-exclusive jurisdiction of . . . any court in the State of New York located in the City and County of New York."[41] In addition, in each I&I Agreement, EMC "waive[d] and agree[d] not to assert by way of motion, as a defense or otherwise in any such suit, action or proceeding, any claim that it is not personally subject to the jurisdiction of such courts, that the suit, action or proceeding is brought in an inconvenient forum, that the venue of the suit, action or proceeding is improper or that the related documents or the subject matter thereof may not be litigated in or by such courts."[42]

40. Defendant Bear, Stearns & Co. (now known as JP Morgan) also is subject to personal jurisdiction in this Court because it is authorized to do business within New York and regularly transacts business within the State.

41. Defendant JPMC Bank is subject to personal jurisdiction in this Court because it is authorized to do business within New York, has offices within the State, and regularly transacts business within the State.

[41] *See, e.g.*, I&I Agreement § 6.05(a) (for each Transaction).

[42] *Id.*

42. Defendants EMC and Bear, Stearns & Co. participated in negotiations and other activities within the State that led to the Transactions that give rise to the claims in this complaint, and the Transactions themselves occurred within the State.

43. Defendants EMC and Bear, Stearns & Co. also submitted to jurisdiction in New York State while this matter was pending in the Southern District of New York, *Ambac Assurance Corp. v. EMC Mortgage Corp.*, Civil Action No. 08 CV 9464 (RMB) (THK). In November 2008, Ambac commenced a breach-of-contract action against EMC in federal court in New York, with subject matter jurisdiction based on the diversity of the parties. After securing discovery of Bear Stearns' files, Ambac moved to amend its complaint to assert additional claims and join Bear, Stearns & Co. (now JP Morgan) as a defendant. In granting that motion, the federal district court repeatedly ruled – initially in a report and recommendation, on reconsideration, and finally on appeal to the district judge – that Ambac is entitled to pursue a common-law claim for fraudulent inducement against both EMC and Bear, Stearns & Co. based on the sufficiency of the allegations as pleaded herein. The federal court also concluded that the joinder of Bear, Stearns & Co. was consistent with principles of fundamental fairness even though it would destroy diversity jurisdiction and require Ambac to re-file its amended complaint in this Court. The district court declined to rule on the viability of Ambac's tortious interference claim, which it left for this Court to determine.

III. BACKGROUND

A. THE BEAR STEARNS MORTGAGE LOAN SECURITIZATION "MACHINE"

44. This action arises from the materially false and misleading disclosures and representations and warranties made by Bear Stearns in connection with the securitization of mortgage loans in four Transactions executed in December 2005, January 2006, September

2006, and April 2007. Each Transaction involved the pooling and sale of mortgage loans to a trust. The trusts issued debt securities of varying seniority, whose payments to investors were dependent on, or "backed" by, the cash flow received from the mortgage payments on the pooled loans. The four Transactions were among hundreds that the Bear Stearns securitization machine churned out from 2005 to 2007.

1. Bear Stearns Controlled Every Aspect of the Securitization Process

45. Through its well-engineered network of affiliates, Bear Stearns controlled every link in the mortgage-loan-securitization chain, including (i) the origination, and financing of the origination, of loans that provided the cash flow for the mortgage-backed securities, (ii) the "warehousing" or temporary financing of large pools of loans pending their pooling and securitization into mortgage-backed securities, (iii) the underwriting, offering, and sale of the mortgage-backed securities, included to funds managed by its affiliates, and (iv) the servicing of loan pools to ensure the continued payment of principal and interest needed to make payments under the mortgage-backed securities. As Bear Stearns' parent, The Bear Stearns Companies, reported in its 2006 Annual Report, this "vertically integrated franchise allows us access to every step of the mortgage process, including origination, securitization, distribution and servicing."[43] Bear Stearns and the affiliates that implemented each of these components of the mortgage-securitization process were directed and controlled by the senior executives and traders sitting in New York, and shared common board members, executives, systems, and resources.[44]

[43] The Bear Stearns Companies Inc., 2006 Annual Report, at 11 (2007).

[44] 4/26/2010 Golden Deposition Tr. at 12-13, 52-53 (stating that the "reporting relationship was to New York" and noting that approximately 50 to 60 individuals had dual titles at Bear Stearns and an EMC entity); 12/11/ 2009 Durden Rule 30(b)(6) Deposition Tr. at 45; 1/22/2010 Megha Rule 30(b)(6) Deposition Tr. at 71-73; 4/15/2010 Gray Deposition Tr. at 48; 5/28/2010 Sears Deposition Tr. at 247-48.

46. Bear Stearns used the offices of EMC in Texas to house its mortgage-loan "conduit" that generated the flow of loans into the securitization pipeline from which the mortgaged-backed securities issued.[45] Mary Haggerty, who was the Senior Managing Director responsible for the conduit's creation in 2001, explained that the EMC conduit acquired mortgage loans for securitization and not to hold in inventory: "[I]f you think of a pipe, water comes in and water goes out as opposed to a pipe leading to a reservoir that's going to be held."[46] EMC thus supplied the Bear Stearns securitization machine with mortgage loans that Bear Stearns had no intention of ever holding, and indeed was loathe to hold, in its own inventory.

47. EMC guided the flow of loans through the pipeline by (i) acquiring and aggregating the mortgage loans to be securitized, (ii) sponsoring the securitizations by selling loan pools to the trusts that issued the securities, and (iii) acting as "servicer" for a large number of the securitized loans, with, among other things, the obligation to collect amounts from the borrowers for the benefit of the trusts. Moreover, as discussed in detail below, EMC also purported to undertake pre- and post-acquisitions reviews and implement other controls to ensure the quality of the loans acquired.

48. The majority of loans EMC acquired for securitization were purchased from large third-party originators, such as American Home Mortgage Investment Corp., SouthStar Funding, LLC ("SouthStar"), SunTrust Mortgage, Inc., Impac Funding Corporation, Just Mortgage, Inc. ("Just Mortgage"), and GreenPoint Mortgage Funding, Inc. ("GreenPoint"). Bear Stearns and its

[45] 4/19/2010 Glory Deposition Tr. at 93-95 (Bear Stearns Managing Director testified that references to the "Bear Stearns Subprime Mortgage Conduit" meant the conduit housed at EMC); EMC Investor Presentation dated July 26, 2006, EMC-AMB 010838314-413 at 315(EMC's conduit operations were headquartered in Dallas, Texas).

[46] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 21.

affiliates extended financing within its originator network,[47] which offered an advance line of funds available to originators to maintain the constant stream of loans acquired by EMC for securitization.[48] Indeed, in the same correspondence offering financing, Bear Stearns reminded the originators that it would pay premium pricing on any loans originated and sold to EMC.[49] Because the originators were not lending their own funds, Bear Stearns encouraged and enabled them to originate a continuous flow of defective loans. Bear Stearns thus provided the means by which these originators approved and generated thousands of mortgages in total disregard of borrowers' ability to repay their debts and which it knew – from due diligence, conducted by third-party firms such as Clayton, and its quality control – violated state laws, including deceptive trade practices and anti-predatory lending laws, such as those requiring that the loan or refinancing must be in the borrowers' best interests.[50]

49. EMC also obtained loans for securitization from its originator affiliates Bear Stearns Residential Mortgage Corporation ("BSRM") and EMC Residential Corporation

[47] Bear Stearns Mortgage Capital Corporation was the warehouse financing facility for Bear Stearns' bulk acquisition channel; EMC Residential housed the warehouse financing facility for loans acquired through the flow acquisition channel. 6/4/2010 Silverstein Deposition Tr. at 93-94; *see also* 4/15/2010 Gray Deposition Tr. at 11-14 (EMC Residential was a warehouse lender that provided funds to correspondent lenders of mortgage loans).

[48] For example, internal EMC documents show that as of May 2005, SouthStar's credit limit with EMC Residential Warehouse Group was increased to $375 million on May 19, 2005 (EMC-AMB 010940606-47, at 631), and remained a "warehouse client" through March 2007 (EMC-AMB 006783646-48). Similarly, Bear Stearns extended credit to Just Mortgage exceeding $65 million between September 28, 2005 and December 22, 2006 (EMC-AMB 010940606-47 at 626). *See also* 6/4/2010 Silverstein Deposition Tr. at 90-94 (confirming that American Home and Impac received financing); 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 249-53 (discussing an e-mail that confirms that SouthStar received financing).

[49] Email from Norman Scott (Bear, Stearns & Co. Inc. Vice President and Product Manager) to CPMC, dated April 4, 2005, EMC-AMB 001254436-437 at 437 ("Bear Stearns have [sic] substantially expanded our Alt-A and Sub Prime product offering and are offering premium pricing for product that is sent to the warehouse facility and purchased by EMC.").

[50] In response to an investigation by the Attorney General of Massachusetts, another investment bank which engaged in similar practices as alleged herein agreed to pay the state $102 million. See Assurance of Discontinuance, In re Morgan Stanley & Co. Inc., No. 10-2538 (Super. Ct. Mass. June 24, 2010).

("EMCRC").[51] From its originator network, BSRM and EMCRC, Bear Stearns generated an enormous volume of residential mortgage loans that it financed, purchased and originated, "with the ultimate strategy of securitization into an array of Bear Stearns' securitizations."[52] Bear Stearns leveraged its multiple roles and affiliates to dictate loan-origination standards for the loans it securitized, either by requiring that loans be originated to its published guidelines or by approving the guidelines used by its larger originators, with whatever changes Bear Stearns believed were necessary.[53] But, Bear Stearns abandoned the protocols necessary to ensure adherence to those guidelines.

50. Bear, Stearns & Co., for its part, acted as lead underwriter and designated its employees as the deal managers to broker the EMC-sponsored securities offerings. It solicited the rating agencies to rate, financial guarantors such as Ambac to insure, and investors to purchase these mortgage-backed securities.[54] Thus, Bear, Stearns & Co. (i) worked with EMC to structure the Transactions,[55] (ii) took the lead in coordinating the flow of documents and information among the rating agencies and parties to the Transactions, (iii) purchased the

[51] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 41-42 (Bear Stearns Residential Mortgage Corporation was a wholesale lender that commenced operations in 2005; its assets were sold to Loan Star funds in May 2008).

[52] *See* Prospectus Supplement ("ProSupp") for SACO 2006-8 Transaction, dated Sept. 14, 2006 ("SACO 2006-8 ProSupp"), at S-29.

[53] Bear Stearns Subprime Mortgage Conduit and EMC Servicing Investor Presentation, EMC-AMB 001421565-597 at 572, 576 (noting process to "approve seller underwriting guidelines."). *See also* 4/26/2010 Golden Deposition Tr. at 54-55 ("[O]n the origination side, I guess we set the – the limits and the type of product that sellers could sell to EMC.").

[54] 4/19/2010 Glory Deposition Tr. at 49-55, 57-59 (testimony regarding EMC and Bear Stearns roles).

[55] *See, e.g.*, ProSupp for SACO 2006-2 Transaction, dated January 26, 2006 ("SACO 2006-2 ProSupp"), at S-39 ("Subsequent to purchase by the sponsor, performing loans are pooled together . . . with the assistance of Bear Stearns' Financial Analytics and Structured Transactions group, for distribution into the primary market."); *see also* SACO 2006-8 ProSupp at S-29; ProSupp for BSSLT 2007-1 (Group I) Transaction, dated April 30, 2007 ("BSSLT 2007-1 (Group I) ProSupp"), at S-35, and ProSupp for BSSLT 2007-1 (Groups II & III) Transaction, dated April 30, 2007 ("BSSLT 2007-1 (Groups II & III) ProSupp"), at S-47.

mortgage-backed securities issued in the Transactions (the "Notes") on a firm commitment basis pursuant to written agreements with the Depositor,[56] and (iv) offered and sold the Notes to investors.[57] The Bear, Stearns & Co. trading organization – reporting to Tom Marano – also made the decisions on the volume of securitizations to effectuate, and, likewise, the volume of loans being acquired by the conduit was "highly controlled by the trading desk."[58] And, as discussed further below, Bear, Stearns & Co. executives made decisions regarding the due diligence, quality control, and repurchase protocols to be followed (or not followed) by EMC in relation to the securitized loans.

51. Bear Stearns' affiliates also frequently purchased or retained a financial interest in a portion of the securities issued in these transactions, which it often repackaged into securities known as "collateralized debt obligations" ("CDOs"). Moreover, then a Senior Managing Director of Bear, Stearns & Co., Ralph Cioffi helped create both the supply and demand for the securitizations, soliciting insurers and investors to participate in its transactions, and then purchasing the securities issued for the investment funds he managed through Bear Stearns affiliates, including Bear Stearns Asset Management. Finally, Bear Stearns provided financial research for residential mortgage-backed securities and related structured products that it created and sold.

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[56] For example, in the SACO 2005-10 Transaction, Bear, Stearns & Co. and the Depositor, Bear Stearns Asset Backed Securities I LLC, entered into an Underwriting Agreement, dated December 12, 2005, and Terms Agreement, dated December 20, 2005, providing that: "Underwriter agrees, subject to the terms and provisions of the above-referenced Underwriting Agreement, which is incorporated herein in its entirety and made a part hereof, to purchase the respective principal amounts of the Classes of the above-referenced Series of Certificates as set forth herein." Bear, Stearns & Co. and the Depositor entered into similar Underwriting Agreements and Terms Agreements in the SACO 2006-2, SACO 2006-8, and BSSLT 2007-1 Transactions with virtually identical language.

[57] The Underwriting Agreements further provide: "It is understood that each Underwriter proposes to offer and/or solicit offers for the Certificates to be purchased by it for sale to the public as set forth in the Prospectus . . . ."

[58] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 86-87.

52. Through Bear Stearns, The Bear Stearns Companies recorded gains and earned fees at every step in this chain: (i) loan-origination fees, (ii) gains on sale of the mortgages to the securitization trusts, (iii) fees from underwriting mortgage-backed securities, (iv) fees from servicing of the securitized loans, (v) fees from CDOs into which these securities were repackaged, (vi) gains and fees from trading in these securities and interests in the CDOs into which they were placed, and (vii) management fees and carried interests from hedge funds and other investment vehicles that invested in the vast array of securities and financial products structured by Bear Stearns and its affiliates that ultimately were backed by residential mortgage loans.

53. As discussed below, the greatest benefit from these fees flowed to the senior executives and traders, who obtained obscene compensation by putting at risk Bear Stearns' ongoing wherewithal.

2. Bear Stearns Churned Out Securitizations by Sacrificing Loan Quality

54. At the time the Transactions at issue in this litigation were consummated, The Bear Stearns Companies had long been a leader in all facets of mortgage-loan securitization, at or near the top of the charts for issuance and underwriting of mortgage-backed securities for 17 years running.[59] The Bear Stearns Companies built this once-stellar reputation on the securitization of large, high-quality loans referred to as "jumbo prime," which was the business it maintained until 2001.[60]

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[59] *See, e.g.*, Asset-Backed Alert, Dec. 31, 2006, *available at:* http://www.abalert.com/Public/MarketPlace/Ranking/index.cfm?files=disp&article_id=1044674725 (ranking Bear Stearns as the fifth-largest issuer of mortgage-backed securities); Q4 2006 The Bear Stearns Companies Earnings Conference Call, Dec. 14, 2006 (stating that, for 2006, "Bear Stearns ranked as the number one underwriter of MBS Securities [mortgage-backed securities] as the Company's securitization volume rose to $113 billion from $95 billion in fiscal 2005, capturing 11% of the overall U.S. mortgage securities market").

[60] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 28, 30.

55. But The Bear Stearns Companies then formed the mortgage-loan conduit at EMC that effectuated the Transactions at issue. The new conduit initially focused on the securitization of "Alt-A" loans, which were made to borrowers that were generally considered more risky than prime borrowers. The profits from the securitizations grew year after year, but took off in 2003, when Bear Stearns began to securitize "subprime" mortgage loans, which it never squarely defines, but that generally constitute loans issued to borrowers with limited incomes or relatively low FICO credit scores due to poor credit history.[61]

56. From 2003 to 2006, The Bear Stearns Companies' revenue and profit increased by 123.8% and 77.6%, respectively, driven in large part by mortgage finance and its securitization machine.[62] For 2006, The Bear Stearns Companies' overall securitization volume rose to $113 billion from $95 billion in fiscal 2005, amounting to 11% of the overall U.S. mortgage-securities market.[63] Consistently, the volume of EMC's securitizations grew markedly over the same period. In 2003, EMC securitized 86,000 loans valued at approximately $20 billion. That number nearly tripled in 2004 to 230,000 loans valued at $48 billion.[64] In 2005, the number jumped to 389,000 loans valued at nearly $75 billion.[65] And in 2006, EMC securitized

[61] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 32-33 (EMC began purchasing subprime loans for securitization); *see also* 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 29-30 (unable to provide a definition distinguishing Alt-A loans from subprime); 4/15/2010 Glory Deposition Tr. at 178-79 (testifying she had no knowledge of whether the definition of subprime changed over time); 5/28/2010 Sears Deposition Tr. at 36-37 (defining a subprime loan as one given to a borrower with "less than pristine" credit history); 6/2/2010 Smith Deposition Tr. at 93 ("I don't believe there was a definition [of subprime]").

[62] The Bear Stearns Companies Inc., Annual Report (Form 10-K), at 79 (Nov. 30, 2006); The Bear Stearns Companies Inc., Annual Report (Form 10-K), at 77 (Nov. 30, 2005).

[63] Q4 2006 Bear Stearns Earnings Conference Call, Dec. 14, 2006.

[64] SACO 2006-8 ProSupp at S-29.

[65] SACO 2006-8 ProSupp at S-29.

over 345,000 loans valued at $69 billion.[66] All told, from 2003 to 2007, EMC purchased and securitized more than one million mortgage loans originally valued in excess of $212 billion.[67]

57. Bear Stearns achieved the dramatic growth in its securitization volume by (i) obtaining an ever-increasing supply of mortgage loans for its securitizations, while (ii) maintaining the demand for the securities backed by those loans.

58. Having already moved from the prime into the Alt A and subprime markets, Bear Stearns further extended the reach of its mortgage portfolio by expanding its use of "reduced documentation" or "no documentation" loan programs. While these programs bear various names (*e.g.*, "Stated Income," "No Ratio," "Stated Income Stated Asset," or "SISA"), they share the common characteristic of requiring less documentation from the borrower than traditional full-documentation loan programs. Accordingly, the reduced- or no-documentation programs were designed to be offered only to certain types of pre-qualified borrowers (*e.g.*, self-employed individuals with very strong credit and substantial equity in the mortgaged property), and the originators supplying the loans were required to use alternative means of assessing the borrowers' ability to repay the loans. However, over time, Bear Stearns and its stable of originators expanded these programs to riskier categories of borrowers in order to increase loan volume.

59. In addition to the expanded use of the reduced-documentation programs, to keep the pipeline full, EMC added second-lien loans and home-equity lines of credit ("HELOCs") to its portfolio of mortgage products. HELOCs, which are among the loans securitized in two of the Transactions, provide borrowers with a revolving line of credit that is generally secured by a secondary lien on the property. EMC's HELOC business began in 2005 with over 9,300

[66] BSSLT 2007-1 (Group I) ProSupp at S-35.

[67] BSSLT 2007-1 (Group I) ProSupp at S-35.

HELOCs valued at more than $509 million and grew to more than 18,000 HELOCs valued at over $1.2 billion by the end of 2006.[68] The growth in its second-lien business was meteoric, with volume skyrocketing from approximately 15,000 loans valued at approximately $660 million at the end of 2004 to approximately 116,500 loans valued at approximately $6.7 billion at the end of 2006.[69]

60. The reduced-documentation programs and second-lien products Bear Stearns exploited had been in use in residential mortgage lending for some time, and were not at the time considered problematic in and of themselves. Rather, the programs and products were appropriate sources of loans *so long as* commensurate controls were implemented and followed to ensure the quality of the securitized loans.

61. As discussed in detail below, Bear Stearns made extensive representations in advance of and at the closing of its securitizations to convince investors and financial guarantors, including Ambac, that it had implemented and was applying the controls required to ensure the quality of these loans. The Bear Stearns Companies underscored the commitment to loan quality to assuage any concerns regarding the pace of its growth:

> [O]ur [origination and] conduit business . . . saw a significant increase in origination volume over the course of the year and that's important not only because it secures a direct pipeline of product for securitization and thereby allows us to maintain and increase share, but also it has a lot to do with the quality of the product that we're able to put out in the nonagency space.[70]

62. The Bear Stearns Companies' pitch was persuasive and worked. Bear Stearns' representations induced Ambac to insure payments due on securities issued from its securitization pipeline, and induced investors to purchase those securities.

[68] BSSLT 2007-1 (Group I) ProSupp at S-35.

[69] BSSLT 2007-1 (Group I) ProSupp at S-35.

[70] The Bear Stearns Companies Investor Conference Call regarding Q4 2005 Earnings, Dec. 15, 2005.

63. But, Bear Stearns did not take steps to ensure the "quality of the product." Quite to the contrary, Bear Stearns pushed for increased loan volumes and expanded its securitization of these products at the expense of underwriting standards.[71] As a consequence, EMC's inventory of mortgage loans was replete with loans (i) originated by fraud, material misrepresentations, or omissions and (ii) underwritten without regard to prudent standards or the fundamental principles of mortgage lending, which require a good-faith assessment of borrowers' ability and willingness to repay the loan.

64. By abandoning appropriate underwriting and due diligence to increase loan volume, Bear Stearns conveyed to each of the Transactions loan pools that were replete with loans that did not comply with the requisite underwriting guidelines and were made to borrowers who did not have the ability to repay their debts. As a result, Bear Stearns marketed and sold billions of dollars worth of securities backed by mortgage loans that did not conform with the disclosures, representations or warranties made as to the loans.

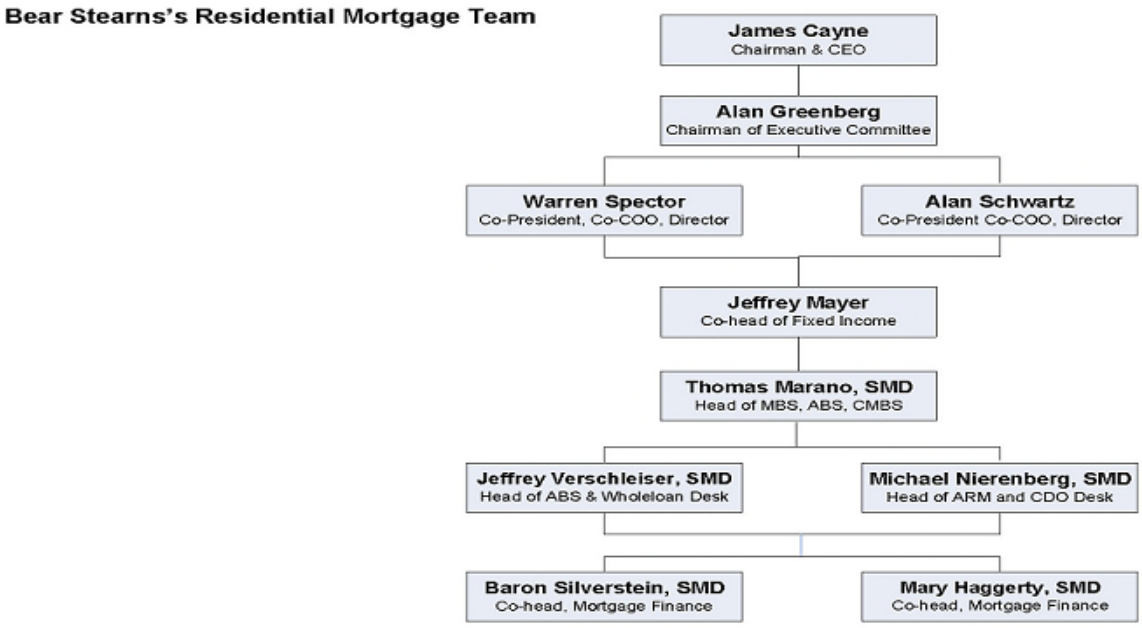
65. Bear Stearns' securitization machine was a successful and extraordinarily profitable enterprise for The Bear Stearns Companies, which further solidified and enhanced its sterling reputation and tremendous sway in all areas of mortgage finance. This success was short-lived. The recently uncovered truth is that Bear Stearns produced and disseminated toxic securities into the marketplace, backed by loans made to borrowers with no ability to pay the amounts as due over the life of the loans. As a result, while Bear Stearns executives reaped

[71] *See Bear Naked Lenders*, Wall St. J., Mar. 18, 2008, at A22 ("Bear took particular pride in its risk management, but let its standards slide in the hunt for higher returns during the mortgage mania earlier this decade."); *see also* Michael Corkery, Fraud Seen as Driver in Wave of Foreclosures-Atlanta Ring Scams Bear Stearns, Getting $6.8 Million in Loans, Wall St. J., Dec. 21, 2007, at A1 ("During its first full year of business in 2006, Bear Stearns Residential Mortgage originated 19,715 mortgages for a combined $4.37 billion, according to data compiled by the Federal Reserve and analyzed by The Wall Street Journal. Bear Stearns Residential Mortgage rejected about 13% of applications, compared with an average denial rate of 29% nationally, according to the Fed data.")

enormous profits, their actions caused the company's sudden collapse in 2008, and destroyed the livelihood of millions of Americans (including those individuals that obtained loans that never should have been approved, or whose retirement plans invested in Bear Stearns' securitizations).

3. Bear Stearns Executives Drove Bear Stearns' Securitization Machine to Assume Inordinate Risk for Personal Gain

66. Bear Stearns' top executives were the key "decision-makers" who drove the Bear Stearns securitization machine and were responsible for Bear Stearns' fraudulent scheme and failure to implement the requisite controls relating to its securitizations. In the marketing materials disseminated to Ambac and investors to induce their participation in the Transactions, Bear Stearns identified, in their official capacities, the senior executives within Bear Stearns' Residential Mortgage Backed Securities Team as follows:[72]



67. From their respective positions in the upper echelons of Bear, Stearns & Co.'s executive management, Cayne, Greenberg, Spector, and Schwartz directed or encouraged the

[72] *See* June 2005 Bear Stearns RMBS Platform, www.emcmortgagecorp.com (ABK-EMC01515471-561 at p.5).

very policies and procedures undertaken to expand securitization volume for the sake of maximizing short-term profitability, with intentional or reckless disregard to the fraudulent disclosures used to market and sell the securities issued in connection with Bear Stearns' residential mortgage-backed securitization transactions. For example, Cayne, Marano, Mayer, Spector and Schwartz received internal audit reports specifying the need to establish and enhance controls relating Bear Stearns' quality control and claims operations, which resulted in the massive, undisclosed profits from the securitization of patently defective loans.[73] But those controls were not implemented, and specifically, the senior executives did not establish requisite protocols to ensure Bear Stearns was not securitizing pools replete with loans made to borrowers with no ability to repay. This upper management of Bear, Stearns & Co. thus enabled and encouraged all of its executives and managers to implement and perpetuate Bear Stearns' fraudulent scheme.

68. Co-Head of Fixed Income Jeffrey Mayer met with Ambac's then-CEO, and Managing Director of Consumer Asset-Backed Securities Department, in advance of the Transactions and represented Bear Stearns in soliciting Ambac's executives to induce Ambac's participation in Bear Stearns' securitizations.[74] Mayer also supervised various aspects of the

[73] Email from Stephanie Paduano (Bear, Stearns & Co. Internal Audit Department) dated March 7, 2006, forwarding EMC Reps & Warrants Internal Audit Report dated Feb. 28, 2006, EMC-AMB 001496304-311.

[74] Email from Darryl Smith (Bear, Stearns & Co., Fixed Income Structured Credit Sales, Securitization Side) to, among others, Nierenberg and Silverstein, dated August 29, 2005, EMC-AMB 003372069-070; Email from Darryl Smith (Bear, Stearns & Co., Fixed Income Structured Credit Sales, Securitization Side) to, among others, Nierenberg and Verschleiser, dated March 23, 2007, EMC-AMB 002290230.

mortgage-finance business, oversaw Bear Stearns' purported loan underwriting guidelines, and received, among other things, internal audit reports and memoranda regarding reserves.[75]

69. In the words of a former Bear Stearns executive, Senior Managing Directors Marano, Nierenberg and Verschleiser acted as the "decision-makers" during the relevant time frame who "were actively involved in running the mortgage business, which included servicing conduit, trading, etc."[76] Tom Marano was the Senior Managing Director and Global Head of Mortgage-Back Securities and Asset-Backed Securities "Decisions about how much risk to put on would have been made by the trading organization, which reported up to Tom Marano" and Marano "would have been well aware of the amount of risk that was being taken on in terms of acquiring assets and . . . the activities with respect to securitization[.]"[77] Marano reported directly to Co-Head of Fixed Income, Jeffrey Mayer.[78]

70. As the Co-Heads of Mortgage Trading, Senior Managing Directors Nierenberg and Verschleiser directly supervised the Co-Heads of Mortgage Finance, Mary Haggerty and Baron Silverstein, and had oversight in all aspects of Bear Stearns' mortgage-finance operations. For example, the traders responsible for determining which loans to package and securitize in the Transactions would report to Verschleiser.[79] In turn, Nierenberg and Verschleiser each reported to Marano.

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[75] *See, e.g.*, email from Stephanie Paduano (Bear, Stearns & Co. Internal Audit Department), *supra* note 72; *see also* email from Marano to, among others, Mayer, dated January 25, 2008, EMC-AMB 005486312-327 (attaching MBS reserve memo).

[76] 4/26/2010 Golden Deposition Tr. at 252. *See also* Teri Buhl, *E-mails Show Bear Stearns Cheated Clients Out of Billions*, The Atlantic, Jan. 25, 2011 ("According to former Bear Stearns and EMC traders and analysts who spoke with *The Atlantic*, Nierenberg and Verschleiser were the decision-makers for the double dipping scheme . . . .").

[77] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 84-85, 91-92.

[78] 4/26/2010 Golden Deposition Tr. at 252.

[79] 6/2/2010 Smith Deposition Tr. at 122-23.

71. As the Co-Heads of Bear, Stearns & Co.'s Mortgage Finance Department, Haggerty and Silverstein each had oversight responsibilities that allowed for, and encouraged, the acquisition of defective mortgage loans to be pooled into the Transactions, and the management of the purported review of the loans before they were securitized. Starting in 2001, Haggerty's responsibilities were to "build," and then manage, "all aspects" of "creating a business where we could buy [loans] and securitize them."[80] She was also the signatory for Bear, Stearns & Co. in the Transaction documents, including the Underwriting Agreements for SACO 2006-2, SACO 2006-8 and BSSLT 2007-1. Between 2000 and 2007, Silverstein was also in charge of "taking a pool of mortgage loans and completing and executing the securitization process," including presentations to the rating agencies, coordinating with the trading desk for the securities to be issued, preparing the Registration Statements, Free Writing Prospectuses ("FWPs"), Prospectuses, and Prospectus Supplements ("ProSupps") (collectively, "Offering Documents") that were publicly filed with the U.S. Securities and Exchange Commission ("SEC") and used to market the securities, reviewing the due diligence performed for the securitized loan pool, and then coordinating the settlement and closing of the securitization transaction.[81] When asked what his specific role was in the process, Silverstein was resolute: "I would not manage – I would be responsible for each of these processes in relation to a securitization."[82]

72. After their securitization, Haggerty and Silverstein continued to oversee and manage the quality control process and, after Ambac submitted demands for repurchase of

[80] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 35-36.

[81] 6/4/2010 Silverstein Deposition Tr. at 36-37; *see also* 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 37-38 (stating that Silverstein was responsible for "the process by which pools of mortgages are sent to a rating agency for analysis and the . . . preparation of the offering documents in connection with a securitization and then the closing and settlement of that securitization").

[82] 6/4/2010 Silverstein Deposition Tr. at 38 (emphasis added).

defective loans, participated in the decisions of whether to honor those demands. In connection with Bear Stearns' acquisition by JPMorgan Chase & Co., JP Morgan hired Haggerty and Silverstein to serve as two of the three Co-Heads of the transaction management group responsible for activities "in connection with sale, purchase, securitization, [and] servicing" of mortgage loans.[83] Haggerty currently works at JP Morgan as a Managing Director in the Securitized Products Group. Silverstein was a Managing Director in Mortgage Finance at JP Morgan until December 2008.

73. Bear Stearns' top executives adopted and succumbed to a compensation structure that created perverse incentives for Bear Stearns to purchase and securitize loans regardless of their quality in order to secure obscene payouts. Indeed, based on publicly available information, CEO James Cayne, Executive Committee Chairman Greenberg, Co-Presidents Alan Schwartz and Warren Spector earned an aggregate total of over ***$1 billion*** in total salary, bonus and stock benefits during the years preceding Bear Stearns' collapse in 2008. Even after accounting for the drop in stock value resulting from Bear Stearns' colossal failure, these individuals made an aggregate ***net payoff exceeding $650 million***. Meanwhile, the firm disintegrated, its shareholders' investments evaporated, and the loans it funded and securitized – and the mortgage-backed securities and other financial products linked to them – have wreaked unprecedented harm on borrowers, investors, and the economy as a whole.

74. These compensation packages for Bear Stearns' top executives are analyzed in a Yale Journal on Regulation article discussing the "moral hazard" risk resulting from the perverse incentives Bear Stearns' executives had to enhance their individual wealth by taking excessive risks with other peoples' money. The article concludes that paying out enormous performance-

[83] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 43. Haggerty admitted that she is also responsible for assisting Bear Stearns in defending litigations such as this one. *Id.* at 46.

based salaries and bonuses created incentives to seek short-term profits by taking excessive risks, including the decision to become heavily involved in the securitized asset markets, that ultimately led to Bear Stearns' failure in 2008:

> [T]he design provided executives with substantial opportunities (of which they made considerable use) to take large amounts of compensation based on short-term gains off the table and retain it even after the drastic reversal of [Bear Stearns'] fortune[]. ***Such a design provides executives with incentives to seek improvements in short-term results even at the cost of maintaining an excessively elevated risk of an implosion at some point down the road***.[84]

75. Similarly, Bear Stearns awarded the lower tiers of executives within Bear Stearns' "Residential Mortgage Team" with extraordinarily high compensation that was ***directly correlated*** to the performance and expansion of Bear Stearns' securitization machine. Consequently, during the height of Bear Stearns' securitization machine, Marano, Nierenberg, and Verschleiser received stratospheric compensation,[85] with the majority paid out as cash bonuses. Others on Bear Stearns' trading desks also were handsomely compensated for increasing the volume and pace at which loans were fed into the securitization pipeline. Between 2005 and 2007, remarkable bonuses were awarded to the trading desk executives that Bear Stearns identified as directly responsible for effectuating each of the Transactions at issue.

76. The means and the motivation were the same – money, and lots of it – to churn out securitizations from the Bear Stearns machine regardless of the consequences.[86]

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[84] *See* Lucian A. Bebchuk, Alma Cohen & Holger Spamann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008* (2010), 27 YALE J. ON REG. 257, 274 (2010)(emphasis added).

[85] The actual dollar amounts of the compensation over time, and correlation to the volume of securitizations, has been deemed "attorneys-eyes only" by Bear Stearns and, therefore, has not been recited herein.

[86] The moral hazard is evidenced by the Bear Stearns senior executives' conduct that was inconsistent with the interests of the shareholders of The Bear Stearns Companies. For instance, Bear Stearns

77. The complete apathy and callous disregard that the architects of these securitizations had for those they were defrauding and harming is illustrated in correspondence involving Jeff Wise, EMC's former senior vice president responsible for seller approval and current Senior Vice President of Seller Approval at JP Morgan. An August 2008 email sent to Wise by a Countrywide executive mockingly revised a New York Times article by journalist Louise Story, which had addressed the alarming market meltdown from the RMBS crisis, to state:

> "Virtually everybody was frankly slow in recognizing that we were on the cusp of a really draconian crisis because ***we were having too much fun waiving shit in and getting loaded on Miller Lite***. Hell! I had a guy that rolled in [sic] Corvette for chrissakes! said Jeff Wise, a former EVP of Credit Risk at Countrywide Securities Corp".[87]

The email contains additional lewd and disdainful comments that will not be recited herein.

4. JPMorgan Chase & Co. Acquired Bear Stearns' Securitization Machine at a Fire Sale in 2008

78. Bear Stearns' house of cards collapsed in the spring of 2008. Following its unprecedented collapse, The Bear Stearns Companies and its affiliates – including EMC and Bear, Stearns & Co. – were acquired by JPMorgan Chase & Co. in a fire sale for only $10 a

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represented to the SEC and the shareholders that it would sell its positions in the Transactions. *See, e.g.*, Email from Michael Sinapi (Bear Stearns & Co.) to Nierenberg and Verschleiser, among others, dated October 5, 2006, EMC-AMB 001496565-567 ("Bear told the SEC that our intent is to sell, not hold, our securities after securitization."). Bear Stearns failed to do so through 2006, and in 2007, shortly after the last Transaction, it rushed to do so, knowing but failing to disclose that its securitizations were doomed to fail. *See, e.g.*, Email from Marano to Nierenberg and Verschleiser, among others, dated May 11, 2007, EMC-AMB 003501771-772 ("You guys need to get a hit team on blowing the retained interest bonds out asap. This is the biggest source of balance sheet problems."). It was too late.

[87] Email from James Baker (and John Relihan) at Countrywide to Jeffrey Wise (EMC Mortgage Corp. Senior Vice President, Seller Approval), and associates at Countrywide, including Adam Gadsby, Adam Robitshek, David Kister, Jeremy Meacham, Jordan Cohen , Peter Van Gelderen and Xerxes Sarkary, dated August 6, 2008, EMC-AMB 010730188 – 91 (emphasis added).

share, which was funded, in part, through a $29 billion non-recourse loan from the American taxpayers.

79. Immediately upon assuming control over of what was left of Bear Stearns, JP Morgan deliberately frustrated investors' and insurers' rights in the Bear Stearns securitizations to avoid JPMorgan Chase & Co. from having to account for Bear Stearns' massive exposure related to its securitizations on its consolidated financial statements. As discussed below, JP Morgan interfered with EMC's contractual obligations including Ambac's and other insurers' and investors' legal remedies relating to the toxic loans backing Bear Stearns securitizations by asserting deceptive and contradicting positions regarding those loans so as to manipulate accounting reserves and block the repurchase of breaching loans in the Transactions.

B. BEAR STEARNS MADE MATERIALLY FALSE AND MISLEADING DISCLOSURES TO INDUCE PARTICIPATION IN ITS SECURITIZATIONS

80. In advance of closing a contemplated securitization deal, Bear Stearns made myriad false and misleading representations directly to investors, insurers, and rating agencies to induce their participation and complete the intended transaction.

81. Bear Stearns followed virtually the same routine in communicating its false and misleading representations to effectuate its securitizations, including the Transactions at issue here. First, Bear Stearns made presentations and disclosures to investors and financial guarantors concerning its securitization operations and the particular transaction contemplated. Second, Bear Stearns provided to the financial guarantors and rating agencies mortgage loan "tapes" (data files with key information for each loan proposed for securitization) that were supposed to contain the true and accurate loan attributes critical to assess the risks associated with the loans to be securitized. Third, Bear Stearns sent financial guarantors information pertaining to the historical performance of loans that Bear Stearns had previously securitized.

Fourth, Bear Stearns secured ratings on various classes of securities to be issued in the contemplated transaction from the rating agencies. Fifth, Bear Stearns disseminated draft and final Offering Documents to financial guarantors and investors purporting to describe the transaction and its associated risks.

1. Bear Stearns Knowingly Made Materially False and Misleading Statements in Its Marketing Presentations and Deal Correspondence

82. Throughout the relevant period, from 2005 to April 2007, Bear Stearns routinely made presentations to investors and financial guarantors to induce their participation in Bear Stearns' securitizations.[88] The presentations were made at Bear Stearns' "Investor Days" by, among others, Bear, Stearns & Co. directors Thomas Marano, Michael Nierenberg, Jeffrey Verschleiser and Ralph Cioffi. The Investor Day presentations were supplemented by direct communications with securitization participants in advance of particular transactions. Bear Stearns' investor relations department and the deal managers responsible for particular transactions disseminated these presentations, which were based on information assembled by, and in conjunction with, employees from its mortgage-loan conduit.[89] As part of the presentations, Bear Stearns provided investors and financial guarantors with information (*e.g.*, PowerPoint presentations known as "marketing decks") concerning the Bear Stearns mortgage-loan conduit and its purported securitization practices.[90]

83. At Bear Stearns' invitation, Ambac attended a number of Investor Day presentations. Bear Stearns provided Ambac with the marketing decks and other documentation

[88] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 121.

[89] 4/19/2010 Glory Deposition Tr. at 69-71.

[90] 4/19/2010 Glory Deposition Tr. at 166-67 (testifying that it was Bear Stearns' practice to provide marketing packages in advance of securitizations).

regarding the Bear Stearns mortgage-loan conduit. And, in advance of the Transactions, Bear Stearns reinforced the disclosures made at the Investor Day and in the marketing decks.

84. By way of example, Bear Stearns gave Ambac a marketing deck in advance of and to induce Ambac's participation in the SACO 2005-10 and 2006-2 Transactions, dated as of June 2005;[91] in advance of and to induce Ambac's participation in the SACO 2006-8 Transaction, dated as of May 11, 2006;[92] and in advance of and to induce Ambac's participation in the BSSLT 2007-1 Transaction, dated as of March 13, 2007.[93] The presentations followed a standardized format, and the 2005 deck is illustrative as to the representations made:

- Integrated Entities: Bear Stearns first emphasized the integrated nature of its securitizations operations. Indeed, the front cover of the presentation is titled "Bear Stearns RMBS Platform," lists an EMC website, and includes Bear, Stearns & Co. Inc.'s name and address. The presentation then provides an organization chart of the "Bear Stearns' Residential Mortgage Team" that shows a seamless reporting line from EMC up to Bear Stearns' Chairman and CEO. Then, to make explicit the interrelation of the affiliates in the mortgage loan conduit, the next slide asks "Why purchase RMBS from Bear Stearns?" and answers by referencing the "Integral role played by Bears affiliate, EMC Mortgage Corporation (EMC)."

- Seller Approval and Monitoring: Bear Stearns next lauded its purported processes for screening and monitoring the originators from which it purchased loans for its securitizations. Among other things, Bear Stearns contended that it tracked metrics regarding the sellers' loans that were predictors of loan quality, including the level of loan EPDs, delinquencies, quality control findings, and repurchases.

[91] Investor Presentation, dated June 2005, ABK-EMC01515471-561.

[92] Investor Presentation, dated May 11, 2006, ABK-EMC01519818-949; *see also* Investor Presentation, undated, attached to the email from Soung Ho Park (Bear, Stearns & Co. Analyst, Mortgage Finance) to Ervin Pilku (Ambac Assistant Vice President, MBS Department of Structured Finance), dated September 13, 2006, ABK-EMC01533424 - 446

[93] Investor Presentation, dated March 13, 2007, attached to the email from Soung Ho Park (Bear, Stearns & Co. Analyst, Mortgage Finance) to Hartmut Ott (Ambac Vice President, MBS Department of Structured Finance), dated March 22, 2007, ABK-EMC01555076-269 ("I have attached the Investor Day Presentation that will give you a better idea of who EMC is and our processes.").

- Due Diligence: Bear Stearns then described the "due diligence" protocols it purported to have implemented to prevent defective mortgage loans from entering the securitizations. For instance, the deck asserted that Bear Stearns conducted due diligence for "100%" of the subprime loans it securitized from its two primary means of acquiring loans, the so-called "flow" and "bulk" channels. To add a false veneer of integrity to the process, Bear Stearns emphasized that it retained the third party due diligence firms Clayton Holdings, LLC. ("Clayton") and Watterson-Prime Consulting LLC ("Watterson Prime") to conduct its pre-acquisition review of the loans.

- Quality Control: Bear Stearns next touted the quality control processes that it purportedly conducted after the securitizations closed to identify any defective loans that may have circumvented its due diligence protocols. As with the due diligence representations, Bear Stearns emphasized the broad scope of its quality control (including random and targeted sampling, referrals from the servicing department and other departments of EMC, and "100%" review of new sellers' loans), the extensive re-verification of loan information purportedly undertaken, and the third party consultants it retained to conduct the analysis.

- Repurchase Processes: Bear Stearns then conveyed that it had an entire "conduit team" devoted to asserting breach-of-representation-and-warranty claims, on behalf of the securitization participants, for the repurchase of loans identified as defective by the quality control process.

- Historical Performance: Finally, Bear Stearns provided appendices with extensive data purporting to reflect the performance of its prior securitizations and the loans therein.

85. Cheryl Glory – the Bear, Stearns & Co. Managing Director for United States Residential Mortgage Backed Securities ("RMBS") Investor Relations – acknowledged that the representations were intended to convey to investors and financial guarantors that (i) Bear Stearns implemented stringent protocols, (ii) to ensure the securitizations contained quality loans, and (iii) for the benefit of the investors and financial guarantors.[94] Haggerty also confirmed that Bear Stearns made these presentations understanding that the information "would

[94] 4/19/2010 Glory Deposition Tr. at 109-10 (Bear Stearns intended investors and financial guarantors to believe they benefited from the quality control processes), 110-119 (Bear Stearns intended investors and financial guarantors to rely on the benefits from the seller approval and monitoring processes).

contribute to the investor's decision to invest in the securitizations," and in order to "solicit their participation in transactions."[95]

86. In advance of each deal, Bear Stearns reinforced the disclosures made at the Investor Days and in the marketing decks through email and oral communications. For example, to underscore the information that Bear Stearns conveyed before the SACO 2005-10 Transaction regarding the purported due diligence conducted on loans, Cheryl Glory sent an email to Ambac titled "Follow-up questions on SACO 2005-10," stating:

> For the SACO 2005-10 deal, Group I is our bulk purchases and Group II is the flow. Our diligence for flow is generally 100%, with a minimum of 20% for a repeat well known seller such as SunTrust. As provided in the presentation materials for Investor Day, flow diligence includes credit, appraisal and compliance for the sample size. Bulk diligence is 100% for subprime and Alt B with a minimum 20% for prime Alt A. Bulk diligence would also include credit, appraisal and compliance for the sample.[96]

87. Similarly, in advance of and to induce Ambac to participate in the BSSLT 2007-1 Transaction, on March 22, 2007, Bear, Stearns & Co. analyst Soung Ho Park provided Ambac with (i) EMC's most recent investor presentation designed to offer a "better idea of who EMC is and our processes," and (ii) newly-implemented underwriting guidelines and matrices, purportedly put in place to originate a large portion of the loans in the BSSLT 2007-1 Transaction.[97] Four days later, Cheryl Glory sent Ambac an email dated March 26, 2007 to (i) lock in a date for a visit by Ambac to EMC's headquarters in Texas, (ii) confirm that Bear

[95] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 113, 121.

[96] Email from Cheryl Glory (Bear, Stearns & Co. Managing Director, Mortgage Finance) to Ervin Pilku (Ambac Associate, MBS Department of Structured Finance), dated December 13, 2005, ABK-EMC01534777. The SACO 2005-10 ProSupp stated that the loans were subprime, and thus purportedly subjected to 100% due diligence review. *See* SACO 2005-10 ProSupp, at S-4.

[97] Email from Soung Ho Park (Bear, Stearns & Co. Analyst, Mortgage Finance) to Hartmut Ott (Ambac Vice President, MBS Department of Structured Finance), dated March 22, 2007, ABK-EMC01555076-077 ("I have attached the Investor Day Presentation that will give you a better idea of who EMC is and our processes. In addition, I have also attached the guideline updates that were effective as of 1/12/07.").

Stearns would provide a representation and warranty concerning the truth of the mortgage-loan data it provided, and (iii) confirm that Bear Stearns would provide to Ambac results of due diligence purportedly conducted on the securitized loan pools:

> I have attached the "Save the Date" for a visit to EMC in April or May. In addition some clarification on the earlier email from Soung: . . . [W]e do provide a rep and warranty that "the information set forth in the Mortgage Loan Schedule hereto is true and correct in all material respects[.]" Jeff will . . . provide you with the due diligence results for all three deals once complete.[98]

88. These communications, which Bear Stearns intended to provide additional assurances to investors and Ambac regarding the quality of the loans and the integrity of Bear Stearns' protocols, were materially false and misleading in several ways. Contrary to its affirmative representations, Bear Stearns knew full well that (i) its due diligence protocols were inadequate to screen out defective loans or deliberately abandoned through overrides,[99] (ii) its seller monitoring controls were a farce,[100] (iii) its quality control and repurchase processes were designed to secure recoveries for Bear Stearns to the exclusion of, and without notice to, the securitizations,[101] and, as a result, (iv) the historical performance data did not reflect the true level of defective loans in the securitized pools. Ambac would not have entered into the Transactions had it known Bear Stearns' disclosures were false and misleading.

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[98] Email from Cheryl Glory (Bear, Stearns & Co. Managing Director, Mortgage Finance) to Gary Gal (Ambac Vice President, MBS Department of Structured Finance), Patrick McCormick (Ambac First Vice President, MBS Department of Structured Finance) and Hartmut Ott (Ambac Vice President, MBS Department of Structured Finance), dated March 26, 2007, ABK-EMC03206645.

[99] *See* Section III.C.1, below.

[100] As early as October 2005, Bear Stearns eliminated its reports that tracked defective loans, and when it downgraded a seller to terminated or suspended status, Bear Stearns stopped conducting quality control of the sellers so it could move the loans into securitizations. *See* Sections III.C.3 and III.C.7, below.

[101] *See* Section III.C.3, below.

2. Bear Stearns Knowingly Disseminated Materially False and Misleading Mortgage-Loan Tapes

89. As part of its initial solicitation to participants in a contemplated securitization, Bear Stearns sent by email certain information concerning the contemplated transaction structure and the loans proposed for securitization. Bear Stearns included in *all* these initial distributions to the financial guarantors and rating agencies the mortgage-loan tape that it asserted contained true, accurate, and complete information pertaining to critical attributes of the loans to be securitized. More specifically, the tapes listed for each loan the data metrics that insurers and rating agencies used as fixed inputs for their cash flow and risk modeling.

90. Consistent with this general practice, Bear Stearns sent loan tapes directly to Ambac in the days leading up to the closing date of each Transaction – on December 28, 2005,[102] January 3, 2006,[103] September 13, 2006,[104] and April 10, 2007.[105]

91. Ambac required and relied on these tapes as a critical component in its decision of whether to provide insurance for the deal, and rating agencies relied on the tapes as a critical component in determining the ratings to be assigned to each class of securities being issued.

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[102] Email from Audrey Kingsley (Bear, Stearns & Co. Inc, Vice President) to, among others, Ervin Pilku (Ambac Associate, MBS Department of Structured Finance) and Patrick McCormick (Ambac First Vice President, MBS Department of Structured Finance), dated December 28, 2005, ABK-EMC01525295-296 (SACO 2005-10).

[103] Email from Audrey Kingsley (Bear, Stearns & Co. Inc, Vice President) to, among others, Ervin Pilku (Ambac Associate, MBS Department of Structured Finance) and Patrick McCormick (Ambac First Vice President, MBS Department of Structured Finance), dated January 3, 2006, ABK-EMC03004619-620 (SACO 2006-2).

[104] Email from Nicholas Smith (Bear, Stearns & Co. Vice President, Deal Manager on SACO 2006-8) to Patrick McCormick (Ambac First Vice President, MBS Department of Structured Finance), dated September 13, 2006, ABK-EMC01536245 (SACO 2006-8); *see also* email from Nicholas Smith (Bear, Stearns & Co. Vice President, Deal Manager for SACO 2006-8) to Ervin Pilku (Ambac Assistant Vice President, MBS Department of Structured Finance), dated June 18, 2006, ABK-EMC01532035 (sending prior version of SACO 2006-8 tape).

[105] Email from Soung Ho Park (Bear, Stearns & Co. Analyst, Mortgage Finance) to Hartmut Ott (Ambac Vice President, MBS Department of Structured Finance), dated April 10, 2007, ABK-EMC01555428 (BSSLT 2007-1).

Ambac used the data on the tapes as fixed inputs to its models, and analyzed the loan metrics, which were central to assessing the risk associated with the loan pool and predicting the expected rates and severity of defaults by the borrowers. The following were some of the key metrics included on the tapes:

- the combined loan-to-value ratio ("CLTV") for each loan, which measures the total amount of mortgage debt that encumbers a property against the value of the property;
- the FICO (or credit) score for each borrower;
- the debt-to-income ratio ("DTI") for each borrower, which compared payments due on a borrower's monthly debts to a borrower's income;
- the occupancy status of the property, which listed whether the property was the borrower's primary or secondary residence, or an investment property; and
- the "doc-type" of each loan, which described the program pursuant to which the loan was originated, and which specified the information borrowers were required to disclose concerning their income, employment, and assets, and how such information would be verified.

92. Bear Stearns knew that Ambac and the rating agencies would rely, and intended that they rely, on the veracity of the tape data to evaluate the Transactions and assess the "market risks" pertaining to the loans.[106] In light of the recent revelations about Bear Stearns' due diligence and quality control practices, it is clear that it fully understood the inadequacy of those controls, and, therefore, knew the tapes contained false and misleading data – or recklessly disregarded the veracity of the disclosures. Indeed, Ambac's loan-level review (conducted at enormous effort and expense after the losses in the Transactions began to mount) has confirmed that those loan tapes contain materially false and misleading data.

[106] 6/2/2010 Smith Deposition Tr. at 67-72, 83; 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 213-15; 4/19/2010 Glory Deposition Tr. at 65.

3. Bear Stearns Knowingly Disseminated Materially False and Misleading Data Concerning the Historical Performance of Its Earlier Securitizations

93. As part of its representations to induce participation in a contemplated securitization, Bear Stearns disseminated historical data showing the performance of previously securitized loans bearing similar attributes to the loans proposed for securitization.

94. Consistent with its general practices, in advance of the Transactions, Bear Stearns included historical performance data in its investor presentations and marketing decks disseminated to Ambac to induce its participation. Bear Stearns also disclosed more detailed historical data in its solicitations leading up to two of the Transactions –SACO 2006-8 and BSSLT 2007-1.[107]

95. Bear Stearns knew that these disclosures were critical to Ambac's assessments of the risks and, ultimately, Ambac's decision to issue its insurance policies in each of the Transactions. Specifically, it knew that Ambac considered and evaluated Bear Stearns' disclosures in advance of the Transactions concerning the performance of comparable loans in previous Bear Stearns securitizations to assess the risks and expected future performance (and, thus, structural protections needed for its financial guaranty insurance) of the loans intended for the contemplated transaction.[108]

96. The historical performance data was materially misleading in that Bear Stearns failed to disclose that it intentionally adopted practices and policies (*e.g.*, its due diligence,

[107] 6/2/2010 Smith Deposition Tr. 158; Email from Soung Ho Park (Bear, Stearns & Co. Analyst, Mortgage Finance) to Hartmut Ott (Ambac Vice President, MBS Department of Structured Finance), dated March 19, 2007, ABK-EMC01554766-768. *See also* E-mail from Patrick McCormick (Ambac First Vice President, MBS Department of Structured Finance) to Nicholas Smith (Bear, Stearns & Co. Vice President, Deal Manager on SACO 2006-8), dated August 8, 2006, EMC-AMB 004311998-999.

[108] Email from Darryl Smith (Bear, Stearns & Co., Fixed Income Structured Credit Sales, Securitization Side) to Patrick McCormick (Ambac First Vice President, MBS Department of Structured Finance), dated March 30, 2007, ABK-EMC01536369-370.

quality control, and EPD policies) that it knew had resulted in the securitization of defective loans in those earlier transactions – loans that were prevented from defaulting solely by virtue of the ability of the borrowers to refinance or sell their homes due to easy credit fueled by an artificially inflated real estate market. Bear Stearns thus knew that prior performance of the loans, including those in earlier Transactions, was not in any way indicative of their quality or the likely performance of the similarly defective loans in the Transactions. Rather, Bear Stearns knew and actively concealed that it was building a house of cards, waiting to collapse as soon as borrowers lost the ability to refinance or "flip" their way out of loans they could not afford to pay. By concealing the true quality of its collateral, Bear Stearns deliberately misled Ambac and other investors into participating in Bear Stearns' securitizations.

4. Bear Stearns Knowingly Supplied Materially False and Misleading Information to Secure Rating Agency Ratings

97. Bear Stearns provided false and misleading information to rating agencies Standard & Poor's, Moody's, and Fitch to secure "shadow ratings" and "final ratings" required to induce financial guarantors to insure and investors to purchase the securities issued in connection with its securitizations, including the Transactions at issue. A shadow rating is an assessment of the value or risk of a mortgage-backed security without consideration of the protection afforded by a financial guaranty insurance policy.[109] A final rating is an assessment of the value or risk of the security taking into consideration the financial guaranty policy.

98. Bear Stearns knew full well that Ambac used the shadow ratings in deciding whether to participate in the Transactions. In fact, Ambac expressly conditioned the issuance of

[109] 4/19/2010 Glory Deposition Tr. at 55-56 ("It's only upon wrapped transactions where the wrapper does not necessarily need to have a rating issued for it to be sold because you're relying on the wrapper's rating."); 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 204. ("A shadow rating is a rating which is not necessarily published . . . it is an expected rating given that certain set of criteria or circumstances are met.").

its financial guaranty insurance policies on the ability to secure a specified shadow rating and a final rating for each Transaction. For example, in connection with the SACO 2005-10 Transaction, Ambac "agreed to issue the Policy . . . subject to satisfaction of the conditions precedent," including that Ambac "shall have received confirmation that the risk insured by the Policy constitutes at least a 'A' risk by S&P, a 'A' risk by Fitch, and a 'A2' risk by Moody's, and that the [insured] certificates when issued, will be rated 'AAA' by S&P, 'AAA' by Fitch and 'Aaa' by Moody's."[110] Likewise, in advance of the BSSLT 2007-1 Transaction, Ambac expressly informed Bear Stearns' representative negotiating the Transaction that its bid "should map to S&P AA rating loss coverage levels, which was a **requirement** when we presented the deal internally."[111]

99. Bear Stearns similarly knew that investors relied, and intended that they rely, on the rating agency ratings in deciding whether to purchase the securities issued in the Transactions. It was for that reason that the Offering Documents used to market the Notes expressly stated that a final rating was a condition precedent to Bear Stearns' offering of the securities.[112]

100. For each of the Transactions, Ambac received shadow ratings that were derived from information supplied to the rating agencies by Bear Stearns. For example, in connection with Ambac's participation in the SACO 2006-2 Transaction, Standard & Poor's issued a "private credit assessment" (*i.e.*, shadow rating) to Ambac stating:

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[110] SACO 2005-10 I&I Agreement § 3.01(x). The I&I for the SACO 2006-2, 2006-8 and BSSLT transactions contain virtually identical language, and differ only in the specific ratings assigned by each agency for the particular Transaction.

[111] E-mail from Hartmut Ott (Ambac Vice President, MBS Department of Structured Finance) to Darryl Smith (Bear, Stearns & Co., Fixed Income Structured Credit Sales, Securitization Side), dated March 21, 2007, ABK-EMC01551116 (emphasis in original).

[112] *See* Section III.B.5, below.

> Pursuant to your request we have reviewed the information presented to us and . . . have assigned a private credit assessment of "A" to these obligations without the benefit of the surety bond. . . . Standard & Poor's relies on the issuer and its counsel, accountants, and other experts for the accuracy and completeness of the information submitted in connection with the private credit assessment.[113]

101. Bear Stearns also solicited and obtained from the rating agencies *final* ratings of the certificates issued in the Transactions, which took into account Ambac's financial guaranty insurance policies.[114] For example, in connection with the SACO 2005-10 Transaction, Standard & Poor's issued a rating letter to Bear, Stearns & Co. stating:

> Pursuant to your request for a Standard and Poor's rating on the above-referenced obligations, we have reviewed the information submitted to us and, subject to the enclosed *Terms and Conditions*, have assigned a rating of 'AAA.' . . . The rating is based on information supplied to us by you or by your agents . . . . Standard and Poor's relies on the issuer and its counsel, accountants, and other experts for the accuracy and completeness of the information submitted in connection with rating.[115]

102. To secure the shadow ratings and, thus the final ratings, Bear Stearns disseminated the same false and misleading data to the rating agencies that it provided to insurers like Ambac, including marketing presentations, loan tapes, and Offering Documents. As a Bear Stearns Managing Director characterized the process:

> So there is a process when you request a rating agency to look at or engage in a specific transaction. You provide them a pool of collateral and you provide them structure. As a result of them providing you [get] back ratings and a rating agency gets picked for a transaction, you will then go down the path of providing to

[113] Letter from Standard & Poor's Ratings Services to Ervin Pilku (Ambac Associate, MBS Department of Structured Finance) regarding SACO I Trust 2006-2, dated January 30, 2006, ABK-EMC01620782-785 at 782 (emphasis added).

[114] 4/19/2010 Glory Deposition Tr. at 55.

[115] Letter from Standard & Poor's to Bear, Stearns & Co. and Ambac, dated December 30, 2005, EMC-AMB 000008015-023 at 8015 (emphasis added). For each of the Transactions, one or more of the rating agencies issued rating letters.

> them marketing materials, such as the term sheet and a pro supp, for them to sign off and understand and then there is a PSA that they will review and provide comments on.[116]

103. The "pool of collateral" that Bear Stearns disclosed to the rating agencies was the same mortgage-loan data provided to Ambac.[117] According to Bear Stearns, the rating agencies used the loan data to model the risk and generate the ratings for the securitizations. The rating agencies would develop models to evaluate "the expected loss or expected probabilities of default for various rating standards," which "took as a given the veracity of the attributes and metrics on the mortgage loan file provided to them."[118] Bear Stearns also gave the rating agencies marketing presentations that included the same false and misleading disclosures made in the marketing decks provided to Ambac and investors.[119] Thus, just as Ambac, in assessing the risk of the Transactions, relied on the truth and accuracy of the loan data Bear Stearns supplied and the representations Bear Stearns made, so too did the rating agencies.[120]

104. EMC generally gathered this requisite information and Bear, Stearns & Co. in turn conveyed it to the ratings agencies.[121] Cheryl Glory, a Bear, Stearns & Co. Managing Director, who was lured away from her position at the Fitch rating agency in 2005 to join Bear

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[116] 4/19/2010 Glory Deposition Tr. at 61-62; *see also id.* at 40-55; *see also* 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 195-97 (same).

[117] Email from Ervin Pilku (Ambac Assistant Vice President, MBS Department of Structured Finance) to Nicholas Smith (Bear, Stearns & Co. Vice President, Deal Manager for SACO 2006-8), dated September 13, 2006, ABK-EMC01524131-132 (in connection with the SACO 2006-8 transaction, "Nick- please let me know if the rating agencies looked at the refreshed tape and the outcome.").

[118] 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 196, 200. Haggerty also confirmed that the "[r]ating agencies typically received collateral information on the individual pools that they were being asked to rate in connection with a transaction and there would be discussion with the rating agencies about the overall platform in general." 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 117-18.

[119] 4/19/2010 Glory Deposition Tr. at 63-64

[120] *See* Section III.B.2, above.

[121] 4/19/2010 Glory Deposition Tr. at 69-70; *see also* 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 200-201 (loan level characteristics and data would be provided to the rating agencies by "an employee of Bear Stearns as the underwriter").

Stearns & Co., was responsible for preparing and disseminating the information to the rating agencies.[122] Bear, Stearns & Co. deal managers also provided information to rating agencies for the transactions they worked on.[123] This included Nick Smith, Bear, Stearns & Co.'s deal manager for the SACO 2006-8 Transaction and wordsmith of the Transaction's "SACK OF SHIT" appellation.[124]

105. Because they were based on the same false and misleading information provided to Ambac and investors, the shadow ratings were false and misleading. The final ratings, in turn, were false and misleading because they were given in reliance on Ambac's insurance policies, which were obtained by virtue of the fraudulently obtained shadow ratings. These ratings therefore added another critical layer of false assurances to investors as to the quality of the securitized loan pools.

5. Bear Stearns Knowingly Made Materially False and Misleading Representations and Disclosures in the Offering Documents to Market and Sell the Notes

106. Bear Stearns marketed the securities issued in its securitizations, including the Transactions, pursuant to Offering Documents[125] that were publicly filed with the SEC pursuant to the Securities Act of 1933. As a matter of law, the Offering Documents were required to disclose all material facts concerning the securities offered; not contain any untrue statement of

[122] 4/19/2006 Glory Deposition Tr. at 15-16, 20 (Bear, Stearns & Co. Managing Director, Cheryl Glory, had worked at Fitch for 8 years prior to her retention), 50 ("I provided the information that I felt would be appropriate to provide to the rating agencies.").

[123] 4/19/2010 Glory Deposition Tr. at 63-64 ("Pitches . . . [c]ould have been provided by the deal management team. So the deal manager responsible for a given transaction.").

[124] Email from Ervin Pilku (Ambac Assistant Vice President, MBS Department of Structured Finance) to Nicholas Smith (Bear, Stearns & Co. Vice President, Deal Manager for SACO 2006-8), dated September 13, 2006, ABK-EMC01524131-132 ("Nick, please let me know if the rating agencies looked at the refreshed tape and the outcome.").

[125] The Offering Documents are defined above to include the Registration Statements, Free Writing Prospectuses, Prospectuses, and Prospectus Supplements.

material fact concerning the securities; not omit to disclose any material fact concerning the securities; and not omit to state a material fact necessary to make the statements made therein, in light of the circumstances in which they were made, not misleading.

107. The Registration Statements and Free Writing Prospectus ("FWPs") were filed with the SEC several days in advance of the contemplated closing date for a securitization; the ProSupps were then filed with the SEC at or around the closing date. The ProSupps filed in connection with the Transactions each state that "Bear, Stearns & Co. Inc., as the underwriter, will offer the certificates listed above at varying prices to be determined at the time of sale."[126]

108. In advance of the closing date for each Transaction, Bear Stearns also prepared and sent to Ambac drafts of the FWPs and the ProSupps to induce its participation in the Transactions. For instance, fifteen days before the December 30, 2005 closing of the SACO 2005-10 Transaction, Bear Stearns' counsel sent Ambac a draft of the FWP.[127] A "preview" of the ProSupp followed eight days later.[128] Indeed, Bear Stearns disseminated updated drafts of the Offering Documents on at least twenty separate occasions prior to closing that Transaction. Similarly, Bear Stearns sent Ambac draft FWPs and ProSupps before the closing date for each of the other three Transactions.[129] The draft FWPs and ProSupps contained false and misleading

[126] SACO 2005-10 ProSupp at S-1; SACO 2006-2 ProSupp at S-1; SACO 2006-8 ProSupp at S-1; BSSLT 2007-1 ProSupp (Group I) at S-1; BSSLT 2007-1 ProSupp (Group II & III) at S-1.

[127] Email from Musa Abdul-Basser (Thacher Profitt & Wood, counsel for Bear Stearns) to Ambac, among others, dated December 15, 2005, ABK-EMC02729306-309.

[128] Email from Musa Abdul-Basser (Thacher Profitt & Wood, counsel for Bear Stearns) to Ambac, among others, dated December 23, 2005, ABK-EMC01528037-8038.

[129] Bear Stearns sent Ambac an initial draft of the FWP fifteen days prior to the January 30, 2006 closing date of the SACO 2006-2 transaction, EMC-AMB 006607559-560; sixteen days prior to the September 15, 2006 closing date of the SACO 2006-8, ABK-EMC03077662-663; and nineteen days prior to the April 30, 2007 closing date of the BSSLT transaction, ABK-EMC02865923-924.

statements and omissions similar to those made in the Offering Documents eventually filed with the SEC.

109. Bear Stearns knew and intended that Ambac and investors would rely on these draft and final Offering Documents in assessing whether to participate in the Transactions. That was the very purpose for which the documents were created and disseminated. Through those disclosures, Bear Stearns deliberately misled investors and induced Ambac to provide financial guaranty insurance for securitizations plagued by defective loans that did not comport with the characteristics represented in the Offering Documents.

110. The disclosures in the Offering Documents of the risks associated with the securitization were false and misleading in that they (i) mischaracterized the origination and underwriting practices, (ii) presented false data metrics pertaining to the securitized loan pools, (iii) provided false and misleading ratings, and (iv) failed to disclose Bear Stearns' complete abdication of its due diligence and quality control processes, which it knew resulted in the securitization of pools replete with defective loans.

111. ***Origination and underwriting practices:*** The Offering Documents sent by Bear Stearns to Ambac and filed with the SEC in connection with each Transaction contained numerous statements purporting to describe the underwriting standards that were applied to assess borrowers' creditworthiness and ensure the quality of the loans in the Transactions. For example, the ProSupp in the BSSLT 2007-1 Transaction (Group I) disclosed that the loans (which consisted of HELOCs) were originated pursuant to underwriting standards designed to "evaluate the borrower's credit standing and repayment ability, and the value and adequacy of

the mortgaged property as collateral," which it also represented were "consistent with those utilized by mortgage lenders generally" at the time.[130]

112. The ProSupps for the Transactions also specifically describe the underwriting guidelines purportedly used by the largest originators of the loans in the Transactions. The ProSupp for the SACO 2006-2 Transaction disclosed that American Home Mortgage Investment Corp., which originated the greatest number of loans for that Transaction and the second-greatest number of loans across all four Transactions, "underwrites a borrower's creditworthiness base[d] solely on information that the Originator believes is indicative of the applicant's ***willingness and ability to pay the debt they would be incurring***."[131] This originator's "underwriting philosophy" is described as "weigh[ing] all risk factors inherent in the loan file, giving consideration of the individual transaction, borrower profile, the level of documentation provided and the property used to collateralize the debit."[132] The ProSupps for the BSSLT 2007-1 (Groups I, II, and III) Transaction similarly discuss the underwriting guidelines employed by GreenPoint[133] and Bear

[130] BSSLT 2007-1 (Group I) ProSupp, at S-28 – S-29; *see also* BSSLT 2007-1 (Groups II & III) ProSupp, at S-41-S-44. *See also* SACO 2006-2 ProSupp at S-34 ("The Originator underwrites a borrower's creditworthiness based solely on information that the Originator believes is indicative of the applicant's willingness and ability to pay the debt they would be incurring."); SACO 2006-8 ProSupp at S-26 (noting that the originator "underwrites a borrower's creditworthiness based solely on information that [it] believes is indicative of the applicant's willingness and ability to pay the debt they would be incurring.").

[131] SACO 2006-2 ProSupp, at S-34 (emphasis added). *See also* SACO 2006-8 Transaction ProSupp at S-25 – S-26 (describing in similar fashion American Home Mortgage Corp.'s underwriting guidelines with respect to HELOCs).

[132] SACO 2006-2 ProSupp, at S-34.

[133] GreenPoint has been faced with a wave of litigation arising from its origination of defective mortgage loans. *See U.S. Bank Nat'l Ass'n v. GreenPoint Mortgage Funding, Inc.*, No. 600352-2009 (N.Y. Sup. Ct. April 14, 2010); *Steinmetz v. GreenPoint Mortgage Funding, Inc.*, No. 08-CV-5367 (S.D.N.Y. June 11, 2008); *Ferguson v. GreenPoint Mortgage Funding, Inc.*, No. 08-CV-60854 (S.D. Fla. June 5, 2008); *Lewis v. GreenPoint Mortgage Funding, Inc.*, No. 1:08-CV-567 (E.D. Va. June 3, 2008); *Ouziz v. GreenPoint Mortgage Funding, Inc..*, No. 3:08-CV-2201 (N.D. Cal. Apr. 29, 2008); *Perez v. GreenPoint Mortgage Funding, Inc..*, No. 5:08-CV-1972 (N.D. Cal. Apr. 15, 2008); *Ramirez v. GreenPoint Mortgage Funding, Inc.*, No. 3:08-CV-369 (N.D. Cal. Jan. 18, 2008); *Knapp v. GreenPoint Mortgage Funding, Inc.*, No. CIV 466080 (Cal. Super. Ct. Sept. 14, 2007); *Feinstein v. GreenPoint Mortgage Funding, Inc.*, No. 07-CV-1851 (E.D. Pa. May 7, 2007).

Stearns Residential Mortgage Corporation (a Bear Stearns affiliate), which originated a significant number of loans in that Transaction.[134]

113. The Offering Documents also explain that the underwriting guidelines allow for ***exceptions*** to be made on a case-by-case basis for borrowers that meet specific criteria described as "compensating factors." For example, the ProSupp for the SACO 2006-2 Transaction notes that "there may be some acceptable quality loans that fall outside published guidelines."[135] The ProSupp asserted that, for these loans, "***common sense***" factors were used to weigh each case individually on its own merits and "exceptions to . . . underwriting guidelines are allowed ***if sufficient compensating factors exist to offset any additional risk due to the exception***."[136]

114. The Offering Documents also disclosed that reduced-documentation loan programs, which accounted for a significant number of the loans in the Transactions, were used for those borrowers that demonstrated their creditworthiness through other compensating factors. For instance, the BSSLT 2007-1 (Group 1) ProSupp states that "[e]xceptions to documentation requirements are reviewed on a case-by-case basis, provided that sound and prudent underwriting practices are followed."[137]

115. Contrary to its representations, Bear Stearns did not exercise any appropriate or meaningful oversight to ensure compliance with the basic risk criteria for prudent and

[134] BSSLT 2007-1 ProSupp (Group I) at S-31 – S-33; BSSLT 2007-1 ProSupp (Groups II & III) at S-41 – S-44.

[135] SACO 2006-2 ProSupp, at S-36. *See also* SACO 2006-8 ProSupp at S-26; BSSLT 2007-1 (Group I) ProSupp at S-31; BSSLT 2007-1 (Group II) ProSupp at S-41 & S-44.

[136] SACO 2006-2 ProSupp, at S-36 (emphasis added); *see also* SACO 2005-10 ProSupp, at S-31 ("The approval process generally requires that the applicant have good credit history and a total debt-to-income . . . that generally does not exceed 38%; however, this limit may be raised if the borrower demonstrates satisfactory disposable income and/or other mitigating factors are present."); SACO 2006-8 ProSupp, at S-26; BSSLT 2007-1 (Group I) ProSupp, at S-31; BSSLT 2007-1 (Groups II & III) ProSupp, at S-41, S-44.

[137] BSSLT 2007-1 (Group I) ProSupp, at S-29 – S-30; *see also* BSSLT 2007-1 (Groups II & III) ProSupp, at S-41, S-44; SACO 2006-S2 ProSupp, at S-34 – S-35; SACO 2006-8 ProSupp, at S-26.

responsible lending. As has now been revealed, based on its own due diligence and quality control results, Bear Stearns knew prior to consummating the respective Transactions that the underwriting standards were abandoned and borrowers' ability to repay the loans was ignored in order to produce as many loans as possible. This was accomplished, in large part, by turning a blind eye to the systematic inflation of borrowers' patently unreasonable stated incomes, by failing to apply the income reasonableness analysis required by the underwriting guidelines, or by placing clearly ineligible borrowers into loan products like so called "no ratio" or "no doc" loans that did not even require them to state their income to obtain a loan. What the Offering Documents also did not disclose is that exceptions to underwriting standards became the rule and originators routinely deviated from the stated guidelines without establishing any of the compensating factors, which were intended specifically to limit exceptions to qualified borrowers.

116. ***Loan data:*** The Offering Documents also contained detailed appendices purporting to represent critical statistical data for stratified segments of the loan pools, including CLTV ratios, DTI ratios, credit scores, property ownership characteristics, and document-types.[138] These characteristics were used by Ambac and potential investors to evaluate the risks and expected performance of the underlying loan pools for the securities issued in each Transaction. As discussed below, based on its due diligence and quality control, Bear Stearns knew that these loan characteristics, as disclosed in the Offering Documents, were materially false and misleading in that they significantly understated the credit risk of the securitized loans.

[138] *See* SACO 2005-10 ProSupp, at Schedule A; SACO 2006-2 ProSupp, at Schedule A; SACO 2006-8 ProSupp, at Schedule A; BSSLT 2007-1 (Group I) ProSupp, at Schedule A; BSSLT 2007-1 (Groups II & III) ProSupp, at Schedule A.

117. ***Ratings:*** The Offering Documents provided that "[i]t is a condition to the issuance of the Offered Notes that each class of the Offered Notes be assigned at least the ratings designated" in the ProSupps.[139] For the SACO 2005-10 Transaction, the rating agencies assigned ratings of "AAA" (Standard & Poor's), "AAA" (Fitch), and "Aaa" (Moody's) for the Notes that had the benefit of Ambac's Policy.[140] And for the SACO 2006-2, SACO 2006-8, and BSSLT 2007-1 (Groups 1, II, and III) Transactions, the rating agencies assigned ratings of "AAA" (Standard & Poor's) and "Aaa" (Moody's) for the Notes that had the benefit of Ambac's Policies.[141] These ratings were given in reliance on Ambac's insurance policies, which were obtained by virtue of the fraudulently obtained "shadow ratings" for the Transactions. As discussed above, the represented credit ratings were, thus, materially misleading in that they were fraudulently obtained from the rating agencies on the basis of Bear Stearns' false and misleading representations concerning the characteristics of the securitized loans and Bear Stearns' omissions of material facts regarding its securitization operations and practices. Had Bear Stearns made truthful and complete disclosures to the rating agencies, the shadow ratings, and thus the final ratings, would not have been obtained and the securities backed by the underlying loans could not have been issued, sold, or insured.

118. ***Controls:*** Bear Stearns' statements in the Offering Documents were also false and misleading because they failed to adequately disclose key risks – that the due diligence, quality control, and repurchase protocols touted in its investor presentations and communications with Ambac and investors were severely flawed and that the Transactions were thus replete with

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[139] SACO 2005-10 ProSupp at S-119; SACO 2006-2 ProSupp at S-128; SACO 2006-8 ProSupp at S-88; BSSLT 2007-1 (Group I) ProSupp at S-108; BSSLT 2007-1 (Group II & III) ProSupp at S-164.

[140] *See* SACO 2005-10 ProSupp at S-119.

[141] *See* SACO 2006-2 ProSupp at S-128; SACO 2006-8 ProSupp at S-88; BSSLT 2007-1 ProSupp (Group I) at S-108; BSSLT 2007-1 ProSupp (Groups II & III) at S-164.

defective loans. In the FWP and ProSupp for the SACO 2005-10 Transaction, Bear Stearns assured Ambac and the Note Purchasers (defined below) that EMC's operations "resemble those of most mortgage-banking companies, except that ***significant emphasis*** is placed on the collection and ***due diligence*** areas, due to the nature of the mortgage portfolios purchased."[142] Nowhere in these documents did Bear Stearns disclose that EMC's due diligence and quality control "operations" were frequently circumvented and insufficient to protect Ambac and investors from the risk posed by inherently defective loans conveyed to the securitizations.

119. The Offering Documents for the SACO 2006-2, SACO 2006-8, and BSSLT 2007-1 Transactions were equally false and misleading. In each FWP and ProSupp, Bear Stearns represented that "[p]ortfolios may be reviewed for credit, data integrity, appraisal valuation, documentation, as well as compliance with certain laws" and that "[p]erforming loans purchased will have been originated pursuant to the sponsor's underwriting guidelines or the originator's underwriting guidelines that are acceptable to the sponsor."[143] Bear Stearns concealed that, in fact, its portfolio review inadequately captured defective loans in the securitization, failing to disclose the utter calamity of its due diligence operations as described below.

C. BEAR STEARNS FAILED TO DISCLOSE AND AFFIRMATIVELY CONCEALED MATERIAL FACTS TO INDUCE PARTICIPATION IN ITS SECURITIZATIONS

120. The representations Bear Stearns made concerning its operations and securitizations to induce investors and insurers to participate in its securitizations markedly diverged from Bear Stearns' actual practices. In addition to its materially false and misleading representations regarding the purported securitization policies, Bear Stearns induced Ambac and investors to participate in each of the Transactions by failing to disclose, and affirmatively

[142] SACO 2005-10 ProSupp, at S-33 (emphasis added).

[143] SACO 2006-2 ProSupp at S-39; SACO 2006-8 ProSupp at S-29; BSSLT 2007-1 (Group I) ProSupp at S-35; BSSLT 2007-1 (Groups II & III) ProSupp at S-47.

concealing, that it implemented policies and abandoned controls to churn out securitizations that it knew, or recklessly disregarded, were replete with loans that did not conform with the represented attributes, were originated in total disregard of actual or prudent underwriting standards, and were made without regard to borrowers' ability to repay.

1. Bear Stearns Knowingly Conducted and Concealed "Bad Due Diligence"

121. Bear Stearns intentionally adopted certain due diligence protocols and deliberately rejected others to ensure the uninterrupted flow of loans into its securitizations regardless of the quality of loans securitized. As a result, Bear Stearns breached the disclosures and representations concerning its due diligence protocols despite knowing – and indeed contemporaneously acknowledging – that Ambac and investors relied on Bear Stearns' due diligence because they did not have sufficient time or ability to re-underwrite the loans given the rapid pace of Bear Stearns' securitizations.[144]

122. Bear Stearns' public disclosures and representations regarding its due diligence were materially false and misleading because Bear Stearns did not disclose, among other things, that it (i) knew its internal protocols were flawed, and rejected repeated recommendations to address the flaws, (ii) knew the due diligence firms it retained were not screening out defective loans but did not replace the firms, despite recommendations that it do so, (iii) routinely overrode the defective loan findings of the due diligence firms and, instead of tracking those overrides as was proposed by the head of its due diligence department, deleted the audit trail relating to those override decisions, (iv) knowingly falsified mortgage loan data to avoid defective loan findings,

[144] Email from Ernest Calabrese, Jr. (Bear, Stearns & Co. Managing Director, Mortgage Finance) to John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) among others, dated September 14, 2005, EMC-AMB 001699864-865 ("These parties have been either performing there [sic] own due diligence (usually not enough time) or piggybacking off of the Clayton/Price results."). Haggerty also confirmed that securitization participants relied on Bear Stearns' disclosures as to the scope of due diligence that was performed. 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 155.

and (v) reduced the amount of due diligence conducted to accommodate its suppliers, thereby securing additional loans. Bear Stearns abandoned its due diligence controls to appease its trading desk's demands for increased loan volume for its securitizations, thereby "trading" loan quality for loan volume – which was lucrative for its executives but greatly detrimental to those who relied on its representations.

123. Starting as early as April 2005, well before the close of the earliest Transaction, the head of Bear Stearns' due diligence department (John Mongelluzzo) made repeated entreaties to the Co-Heads of Bear, Stearns & Co.'s Mortgage Finance department in charge of the EMC mortgage-loan conduit (Haggerty and Silverstein) to revise its due diligence protocols.[145] Recognizing that the existing protocols allowed the purchase and securitization of defective loans, Mongelluzzo proposed to rank loans slotted for due diligence by risk criteria and apply incremental resources to the review of each successive gradation of loan.[146] As Silverstein conceded, this proposed change was "significant" and not mere "incremental Darwinian creep" in the evolution of a diligence process.[147] But, Bear Stearns elected *not* to implement this "significant" change to its due diligence protocols in 2005 or in 2006 (when the first three Transactions were closed). Then, in March 2007, Mongelluzzo renewed what he admitted was

[145] *See*, *e.g.*, Email from John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) to Mary Haggerty and Baron Silverstein (Bear, Stearns & Co. Senior Managing Directors, Co-Heads Mortgage Finanace), dated April 26, 2005, EMC-AMB 001597507-508 (Proposing "New Due Diligence Processes" including "Identify higher risk loans within sample to DD firms so that more seasoned UW's are reviewing the loans.").

[146] Email from John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) to Mary Haggerty and Baron Silverstein (Bear, Stearns & Co. Senior Managing Directors, Co-Heads Mortgage Finanace), dated May 11, 2005, EMC-AMB 001597504 ("We should also identify the top 25% of loans with the sample that we feel pose the largest risk potential. Both Clayton and PWC upon having those loans tagged/identified can place their most seasoned underwriters to review the loans and also perform additional QC on the loans. Both of these processes are ones that we can use to market our process to investors and the rating agencies going forward.").

[147] 6/4/2010 Silverstein Deposition Tr. at 178; 4/21/2010 Mongelluzzo Deposition Tr. at 172.

the *same* proposal made in 2005, underscoring its import by stating "I think we need to completely revamp how we do due diligence."[148] Mongelluzzo urged the due diligence protocols to be "completely revamped" because it was well known *within* Bear Stearns that the existing diligence protocols were not screening defective loans from the securitizations. As Mongelluzzo and other Bear Stearns executives testified, however, this significant and necessary change to its due diligence protocol – initially proposed in 2005 and renewed in March 2007 – was *not* implemented before the final Transaction in this matter closed on April 30, 2007.[149]

124. Mongelluzzo's proposal to identify and apply increased resources to the review of riskier loans was just one of the many significant due diligence improvements he recommended that were rejected by Bear Stearns' management. In early 2006, Mongelluzzo also proposed that the entire due diligence process be taken away from the due diligence firms used by Bear Stearns (*i.e.*, Clayton and Watterson Prime) and be brought in-house.[150] Mongelluzzo proposed to move the due diligence process in-house because he knew that the diligence firms were not screening out defective loans from the pools purchased for securitization.[151] That was a view shared by Bear Stearns' senior executives.

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[148] Email from John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) to Mary Haggerty and Baron Silverstein (Bear, Stearns & Co. Senior Managing Directors, Co-Heads Mortgage Finanace), among others, dated March 6, 2007, EMC-AMB 001431086 ("Based on that risk score we would determine the type of diligence to be done. The highest level of risk would get the most comprehensive review."); 4/21/2010 Mongelluzzo Deposition Tr. at 174-75.

[149] 4/21/2010 Mongelluzzo Deposition Tr. at 175. In fact, the proposal was never fully implemented, but only on a test-case basis later that year.

[150] Email from Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk) to, among others, Michael Nierenberg (Bear, Stearns & Co. Senior Managing Director, Head of ARM and CDO Desk), dated March 23, 2006, EMC-AMB 001542438-439 (responding to Mongelluzzo's proposal); 4/21/2010 Mongelluzzo Deposition Tr. at 195-96.

[151] As early of May 2005, Mongelluzzo proposed to move the due diligence business away from Clayton because its performance had not been good. *See* Email from John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) to Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finanace), among others, dated May 31, 2005, EMC-AMB 005107100-101 ("We should

125. In March 2006, following Mongelluzo's recitation of the failings of the due diligence firms, Verschleiser stated in no uncertain terms that "***we are wasting way too much money on Bad Due Diligence***" conducted by Clayton.[152] Bear Stearns nonetheless rejected Mongelluzzo's proposal and kept the due diligence firms in place. Not surprisingly, therefore, a year later in March 2007, Verschleiser echoed almost verbatim his prior conclusion regarding Clayton Holding's failings, stating ***"[w]e are just burning money hiring them***," a sentiment with which Nierenberg "agree[d]."[153]

126. The issue, as Bear Stearns fully recognized, was that the due diligence firms did not adequately re-underwrite the loans proposed for securitization to assess the borrowers' ability to repay, which was and is a fundamental inquiry under all underwriting guidelines. Accordingly these firms were destined to miss wide swaths of defective loans. Indeed, Verschleiser's denouncement of Clayton in March 2007 – a month before the closing of the BSSLT 2007-1 Transaction – was a direct reaction to a report Mongelluzzo provided that showed the deficiencies of Clayton's findings. The report showed that in 2006 Clayton had reviewed a total of 58,643 loans, but that only 2,078 – or less than 3.5% – were "kicked in the [due] diligence

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look to direct business to Mortgage Ramp from Clayton starting with smaller jobs most preferably (since this is Claytons most expensive job to do for us). Also jobs that are shipped to Clayton might be a good target ***since the performance in their central location has not been as good as we like***."). By the third quarter of 2005, the third party due diligence firms' performance was so bad as to inspire Verschleiser to request EMC to track the material issues they missed. *See* email from Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President), dated November 1, 2005, EMC-AMB 003500070 ("JV has asked us to start logging loans that we believe Clayton or PWC missed material issues on . . . . Linda please start the list with the loans from yesterday and let's keep it on the shared drive.").

[152] Email from Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk) to, among others, Michael Nierenberg (Bear, Stearns & Co. Senior Managing Director, Head of ARM and CDO Desk), dated March 23, 2006, EMC-AMB 001542438-439.

[153] Email from Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk) to, among others, Michael Nierenberg (Bear, Stearns & Co. Senior Managing Director, Head of ARM and CDO Desk), dated March 15, 2007, EMC-AMB 005446200.

process" for defects.[154] As Verschleiser's comment reflects, Bear Stearns knew that the level of defective loans in its pools far exceeded 3.5%. Significantly, the same summary revealed that of those loans rejected, only 310 loans – or just ***0.05%*** of the total loans Clayton reviewed – were identified as having unreasonably stated income. The Bear Stearns executives involved in the exchange, knew that a prevalent defect in its loan pools pertained to borrowers who falsely and unreasonably stated their incomes, but that Clayton had failed to adequately evaluate the reasonableness of the borrowers' incomes. Mongelluzzo admitted as much in an August 2007 response to an inquiry of whether Clayton assessed the reasonableness of income between 2004 and 2006, when he explained that Clayton "***looked at it back then but not as hard***."[155]

127. Bear Stearns had an equally low regard for the adequacy of the review conducted by Watterson Prime and of that firm's ability to identify defective loans.[156] Thus, Mongelluzzo's proposal to bring the due diligence function in-house encompassed the work performed by Watterson Prime.[157] By April 2007, moreover, the problems with Watterson Prime had become so severe that Mongelluzzo advised his team that Bear Stearns "will temporarily cease using them for due diligence services."[158] Rather than disclose these issues in advance of the BSSLT

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[154] *Id.*

[155] Email from John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) to Cheryl Glory (Bear, Stearns & Co. Managing Director, Mortgage Finance), dated August 30, 2007, EMC-AMB 001433099-100.

[156] *See, e.g.*, Email from Jose Carrion (EMC Mortgage Corporation, Subprime Underwriting Manager) to, among others, Haggerty, Silverstein, Jo-Karen Whitlock (EMC Mortgage Corporation Senior Vice President, Conduit Operations), dated December 19, 2006, EMC-AMB 005434366 ("Due to a back log on receiving reports and failure to meet deadlines until further notice, ***do not assign any new trades to Watterson-Prime*** without my prior approval.") (emphasis added).

[157] 6/4/2010 Silverstein Deposition Tr. at 116-17 ("evaluating bringing in-house our due diligence efforts versus outsourcing to Clayton and Prime and other due diligence firms").

[158] E-mail from John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) to, among others, Pattie Sears (EMC Mortgage Corporation, Due Diligence Manager) and Jose Carrion (EMC Mortgage Corporation, Subprime Underwriting Manager), dated April 13, 2007, EMC-AMB 001747707-708

Transaction, which was scheduled to close two days later, an EMC manager directed the diligence department to "make sure this stays within EMC only."[159] When asked her view of Watterson Prime, the manager who was the point of contact with Watterson Prime recommended that the firm not be hired in the future because "***Watterson~Prime . . . does not always deliver***."[160] And in the words of a former Watterson Prime consultant that conducted due diligence on Bear Stearns loans, "the vast majority of the time the loans that were rejected were still put in the pool and sold."[161] That consultant, who worked at both Watterson Prime and Clayton in performing due diligence of loans purchased by Bear Stearns for securitization, also recently confirmed that Bear Stearns directed its due diligence firms to perform only a cursory review that was little more than a rubber stamp. To comply with Bear Stearns' mandate, Clayton and Watterson Prime instructed their reviewers to grade loans as "level 1", which indicated that the loan met guidelines and should be purchased, even if the reviewer reasonably believed that the borrower did not have the ability to repay the loan or if the stated income seemed unreasonable.[162]

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[159] E-mail from Jose Carrion (EMC Mortgage Corporation, Subprime Underwriting Manager) to, among others, Jo-Karen Whitlock (EMC Mortgage Corporation Senior Vice President, Conduit Operations) and Pattie Sears (EMC Mortgage Corporation, Due Diligence Manager), dated April 13, 2007, EMC-AMB 001747707-708.

[160] Email from Pattie Sears (EMC Mortgage Corporation, Due Diligence Manager) to Debbie Rich (EMC Mortgage Corporation, Quality Control), dated July 16, 2008, EMC-AMB 006177517-518 ("Our major issues, ARM issues, prepayment penalty issues, etc., were always WP."); 5/28/2010 Sears Deposition Tr. at 181-188.

[161] 8/28/2010 Warren Deposition Tr. at 46; *see also* Chris Arnold, *Auditor: Supervisors Covered Up Risky Loans*, National Public Radio, dated May 27, 2008, http://www.npr.org/templates/story/story.php?storyId=90840958 (statement from Tracey Warren that "[a]bout 75 percent of the time, loans that should have been rejected were still put into the pool and sold"); Email from Anthony Neske (Watterson Prime LLC) to John Mongelluzzo (Bear Stearns & Co. Vice President, Due Diligence), dated May 29, 2008, EMC-AMB 005964024-025 (discussing the Waterson Prime employee's public admissions).

[162] 8/28/2010 Warren Deposition Tr. at 36-37 ("Did I see a lot of loans that looked like they were going to be problematic, come down the pike? Yes. Did they meet their guidelines? Unfortunately, yes," but "I saw a lot of loans that were stated and limited documentation loans, which while they met the lenders'

128. Bear Stearns did not disclose to Ambac or the other securitization participants its deep-rooted concerns regarding the failings of its due diligence firms; nor did Bear Stearns adopt Mongelluzzo's proposal to bring the due diligence function in-house to address the failings. At his deposition, Baron Silverstein contended that Bear Stearns rejected the significant change to its diligence structure "because there weren't significant cost savings associated with bringing it in-house."[163] But Bear Stearns' own internal analysis showed a potential cost savings in the year of implementation, $3.6 million in savings in the second year, and $6.7 million annual savings by the fifth year.[164] These escalating cost *savings* were not "significant" enough for Bear Stearns to move away from the *internally*-berated but *publicly*-praised due diligence firms? The truth is that Bear Stearns rejected Mongelluzzo's proposal to bring the due diligence function in-house because the third party due diligence firms provided the false veneer of credibility to the process that Bear Stearns marketed to Ambac and other securitization participants.

129. Revealing of its actual motivation, *i.e.*, to allow the free flow of loans into its securitizations regardless of quality, Bear Stearns also rejected Mongelluzzo's proposal to track the extent and reasons for Bear Stearns' "overrides" of the due diligence firms' conclusions even in those instances where they concluded that loans were defective and should not be purchased. In May 2005, before any of the Transactions at issue had closed, Mongelluzzo requested that Haggerty and Silverstein approve his request "to track loans that are overridden by our due

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guidelines, they cannot necessarily make sense" meaning that "the loans were made to borrowers that . . . did not have a reasonability [sic] to repay."); *id.* at 39 ("There was a high chance that the loan would go into default . . . based on the credit," but although "the borrower likely would not be able to pay," "if it was stated [income] and it met the guidelines, it would be a one.").

[163] 6/4/2010 Silverstein Deposition Tr. at 120-21.

[164] Due Diligence – "Build Initiative" Presentation, dated May 1, 2006, EMC-SYN 00597826-828. *See also* Email from Mongelluzzo to Verschleiser and Nierenberg, among others, dated February 15, 2006, EMC-AMB 001542438-439 ("I ultimately think if we brought all of the DO in house we would run savings of about $6MM annually based on our current DO spend.").

diligence managers and track the performance of those loans."[165] Haggerty previously had been advised by the due diligence department that maintaining the documentation of the due diligence firms' analysis would allow Bear Stearns to track "trends in the reasons for rejection" and for "trades that actually turn into deals determine how different credit performance is for loans that had been flagged as 'exceptions' vs. those that were not."[166] But the particular reasons for its overrides and the "exceptions" it made to underwriting guidelines to allow defective loans to be purchased were exactly what Bear Stearns did *not* want to be tracked.

130. Thus, Bear Stearns did not implement Mongelluzzo's proposal; instead, it did the exact opposite, implementing and maintaining throughout the relevant period a policy that directed its underwriting managers communicating with the due diligence firms to "purg[e] all of the older reports on the trade leaving only the final reports."[167] A Bear Stearns due diligence manager confirmed that, pursuant to this policy, she did not retain copies of the "daily reports" submitted by the due diligence firms.[168] Bear Stearns therefore destroyed evidence and impaired the audit trails concerning the high incidence of Bear Stearns' overrides and waivers leading up to its final purchase decisions.[169]

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[165] Email from John Mongelluzzo (Bear Stearns & Co. Vice President, Due Diligence) to Haggerty and Silverstein, dated May 11, 2005, EMC-AMB 001597504.

[166] Email from Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finanace), dated April 25, 2005, EMC-AMB 001699079-080.

[167] *See* Email from Jose Carrion (EMC Mortgage Corporation, Subprime Underwriting Manager) to Jo-Karen Whitlock (EMC Mortgage Corporation Senior Vice President, Conduit Operations), dated May 17, 2006, EMC-AMB 004416519-525, at 524 (attaching the EMC Conduit Manual, Bulk Underwriting Chapter, dated April 30, 2005).

[168] *See* Email from Jose Carrion (EMC Mortgage Corporation, Subprime Underwriting Manager) to Jo-Karen Whitlock (EMC Mortgage Corporation Senior Vice President, Conduit Operations), dated May 17, 2006, EMC-AMB 004416519-525 at 524 (attaching the EMC Conduit Manual, Bulk Underwriting Chapter, dated April 30, 2005); 5/28/2010 Sears Deposition Tr. at 101-03.

[169] *Id*.

131. What Bear Stearns could not prevent, however, was that one of its due diligence firms – Clayton – would attempt to shield itself from criticism by internally tracking the override decisions made by Bear Stearns. Consequently, Clayton's president had prepared a report that showed that Bear Stearns waived Clayton's findings that defective loans should not be purchased ***up to 65% of the time*** in the third quarter of 2006 alone.[170] Indeed, during the height of its mortgage securitization practice in 2006, Bear Stearns waived an even higher percentage of Clayton's due diligence findings. And, by 2007, Bear Stearns still was waiving one out of every five loans that Clayton rejected.[171]

132. Bear Stearns was thus purchasing loans despite knowing about material defects that Clayton identified during due diligence. For example, Clayton reported that 11% of defective loans that Bear Stearns waived involved "Loan Characteristics [that] do not match any available program."[172] Despite purporting to tighten its controls in the first half of 2007, Bear Stearns did the opposite. The exception Bear Stearns most commonly waived at that time was "Stated Income not [sic] Reasonable"[173] – the very same problem that by August 2007 Mongelluzzo criticized Clayton for not assessing properly.[174] For 2006 and through the first half of 2007, the top five loan defects waived by Bear Stearns related to Terms/Guidelines, Credit

[170] Internal Report produced by Clayton Holdings, Inc., CLAY-AMBACE 0001770-780 at 1777 (showing a 65% override rate for EMC and 56% rate for Bear Stearns in the third quarter of 2006).

[171] All Clayton Trending Reports: 1st Quarter 2006 – 2nd Quarter 2007, published by the FCIC.

[172] Bear Stearns/EMC Trending Report Executive Summary. CLAY-AMBAC-021507.

[173] Bear Stearns/EMC Trending Report Executive Summary. CLAY-AMBAC-021507.

[174] Email from John Mongelluzzo (Bear, Stearns & Co. Vice President, Due Diligence) to Cheryl Glory (Bear, Stearns & Co. Managing Director, Mortgage Finance), dated August 30, 2007, EMC-AMB 001433099-100.

History, Assets, Income/Employment, and Appraisal. All of these are material problems, which should result in a loan being rejected.[175]

133. The common rationale pervading Bear Stearns' due diligence decisions was to ensure that the diligence protocols did not impede, but rather facilitated, the free flow of loans for securitization. This directive was set early and enforced firmly. Thus, as early as February 2005, Haggerty issued the strong directive to *reduce* the due diligence Bear Stearns conducted "in order to make us more competitive on bids with larger sub-prime sellers."[176] As she conceded, reducing due diligence was an accommodation to the suppliers that ensured the flow of mortgage loans that Bear Stearns securitized.[177] Pursuant to Haggerty's directive, Bear Stearns reduced the size of the loan samples it subjected to due diligence and agreed to conduct due diligence *after* the loans were purchased, *i.e.*, "post-closing" due diligence. Both changes reduced the effectiveness of the diligence, and neither was disclosed to Ambac or investors.[178]

134. Consistent with its response to Mongelluzzo's other recommendations, Bear Stearns paid no heed to the warnings by the head of its quality control department regarding the adverse consequences that would result from such limitations. For example, to increase the flow of loans from high-volume originators such as American Home Mortgage (whose lending operations Bear Stearns also helped finance through its warehouse lines of credit), Bear Stearns' trading desk agreed to conduct "post close due diligence" for two loan pools purchased in March

[175] Bear/EMC Waiver Trending Report by Category, Credit Exceptions, CLAY-AMBAC-021505.

[176] Email from John Mongelluzzo (Bear, Stearns & Co. Vice President of Due Diligence) conveying instructions from Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finance) to reduce due diligence, dated February 11, 2005, EMC-AMB 001718713-714.

[177] 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 194.

[178] As Bear Stearns' internal audit department noted, it did not have any "documented process for determining loan sample selections that deviate from the due diligence guidelines," let alone any process for communicating those deviations to securitization participants. Internal Audit Report, dated June 22, 2006, EMC-AMB 010858558-561.

and June 2006.[179] When Mongelluzzo learned of this decision in March, he advised the trading desk and Silverstein that "I would strongly discourage doing post close for any trade with [American Home Mortgage]. You will end up with a lot of repurchases" for defective loans in the securitized pools.[180] Bear Stearns disregarded that advice. Instead, it purchased the two loan pools and quickly packaged over 1,600 loans in the SACO 2006-8 Transaction, making American Home Mortgage the principal originator in the Transaction.[181]

135. Similarly, in February 2007, Mongeluzzo warned Silverstein that "we need to let the desk know and seriously change our sampling percentages."[182] Mongelluzzo's concern stemmed from the large number of defective loans that Bear Stearns' quality control department identified in the securitized loan pools. Again the warning was disregarded, and Silverstein

[179] Email from David Elliott (EMC Mortgage Corporation Deal Manager) to Keith Lind (Bear Stearns & Co. Managing Director, Trading), dated June 23, 2006, EMC-AMB 002314578-579 (describing American Home Mortgage "as turning out to be a post close due diligence"); E-mail from Keith Lind (Bear Stearns & Co. Managing Director, Trading) to John Mongelluzzo (Bear Stearns & Co. Vice President, Due Diligence) and David Elliott (EMC Mortgage Corporation Deal Manager), among several others, dated March 28, 2006, EMC-AMB 001751435-436 ("We will be doing 100% (Credit/Compliance) post closing due diligence on this pool.").

[180] Email from John Mongelluzzo (Bear Stearns & Co. Vice President, Due Diligence) to Keith Lind (Bear Stearns & Co. Managing Director, Trading), David Elliott (EMC Mortgage Corporation Deal Manager), and Baron Silverstein (Bear Stearns & Co. Senior Managing Director, Co-Head Mortgage Finance), dated March 28, 2006, EMC-AMB 001751435 (emphasis added). *See also* Silverstein Deposition Tr. at 127-29.

[181] This was not an isolated problem. In March 2006, one of its deal managers observed that Bear Stearns completely abandoned doing any due diligence for flow loans that it had securitized, stating that "on the flow side we had no idea until yesterday that there was post close dd going on. . . . I agree that flow loans were not flagged appropriately and we securitized many of them which are still to this day not cleared. I think the ball was dropped big time on the flow processes involved in the post close dd, from start to finish." Email from Robert Durden (Bear, Stearns & Co. Deal Manager) to Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President), dated March 24, 2006, EMC-AMB 006802393-395.

[182] Email from John Mongelluzzo (Bear Stearns & Co. Vice President, Due Diligence) to Baron Silverstein, among others, dated February 22, 2007, EMC-AMB 005469676-677.

shortly thereafter proposed to reduce the percentage of loans sampled for GreenPoint, one of the largest originators of defective loans in Bear Stearns' securitizations.[183]

136. In addition to pushing for reduced due diligence, Bear Stearns' trading desk pressured the due diligence department to churn through loans at such a rate as to make any legitimate diligence impossible to attain. For example, on April 4, 2006 – at Verschleiser's behest – EMC's Senior Vice President of Conduit Operations directed her staff to do "whatever is necessary" to meet Bear Stearns' volume objectives:

> I refuse to receive any more emails from [Verschleiser] (or anyone else) questioning why we're not funding more loans each day. I'm holding each of you responsible for making sure we fund at least 500 each and every day. . . . [I]f we have 500+ loans in this office we MUST find a way to underwrite them and buy them. . . . ***I was not happy when I saw the funding numbers and I knew that NY would NOT BE HAPPY. I expect to see 500+ each day. . . . I'll do whatever is necessary to make sure you're successful in meeting this objective***.[184]

Several months later, on September 26, 2006, the same Senior Vice President again ordered her staff to "hit the target number" required by Bear Stearns' trading desk, which required EMC to underwrite and purchase $2 billion in mortgage loans in just one month.[185]

137. The pressure to increase volume at the expense of quality was confirmed by a former EMC mortgage analyst, Matthew Van Leeuwen, who revealed that, among other due diligence abuses, Bear Stearns' focus on loan acquisition was "short term," and that traders

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[183] Email from Baron Silverstein to John Mongelluzzo (Bear Stearns & Co. Vice President, Due Diligence) and others, dated May 29, 2007, EMC-SYN 00416564

[184] Email from Jo-Karen Whitlock (EMC Mortgage Corporation Senior Vice President, Conduit Operations), dated April 14, 2006, EMC-SYN 00596927-928 (emphasis added).

[185] Email from Jo-Karen Whitlock (EMC Mortgage Corporation Senior Vice President, Conduit Operations), dated September 26, 2006, EMC-SYN 00596855-856 ("I don't understand that with weekend overtime why we didn't purchase more loans today (Monday). . . . ***Our funding needs to be $2 billion this month. . . . I expect to see ALL employees working overtime this week to make sure we hit the target number***.") (emphasis added).

sought to "get cheap loans and sell them at a huge profit margin."[186] A series of emails between the same EMC mortgage analyst, and journalists provides further "disturbing accounts of what was happening behind the scenes" at Bear Stearns.[187] Specifically, in these emails Van Leeuwen admitted that "the pressure was pretty great for everybody to just churn the mortgages on through the system" so that if there were "outstanding data issues . . . analysts would 'fill in the holes.'"[188] As an example, Van Leeuwen explained how "[a] missing credit score would magically become a 680 in Bear's system, things like that."[189] As Van Leeuwen explained in a May 2010 email to journalist Teri Buhl at the *Atlantic*, Bear Stearns' skewed incentives and resulting failures of due diligence affected documentation type data on the mortgage loan tape in addition to credit scores:

> [A] snap decision would be made up there (in NY) to code a documentation type without in-depth research of the lender's documentation standards. . . . [W]e don't want to waste the resources on deep investigation: that's not how the company makes money, that's not our competitive advantage, it eats into profits, etc. If a documentation type, as given by a lender, is erroneous, Bear can point the finger at the lender thanks to indemnification agreements. With that type of protection in this kind of situation, a minimal level of scrutiny is required−and thus ***why worry too much about it? The loans will be off the books soon enough.***[190]

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[186] 9/25/2010 Van Leeuwen Deposition Tr. at 86, 110-11

[187] Email from Matthew Van Leeuwen (EMC Mortgage Corporation Analyst, Trade Support) to Nick Verbitsky (Blue Chip Films), dated March 25, 2009, EMC-SYN_VL 0004.

[188] Email from Matthew Van Leeuwen (EMC Mortgage Corporation Analyst, Trade Support) to Nick Verbitsky (Blue Chip Films), dated March 30, 2009, EMC-SYN_VL 0006.

[189] Email from Matthew Van Leeuwen (EMC Mortgage Corporation Analyst, Trade Support) to Nick Verbitsky (Blue Chip Films), dated March 30, 2009, EMC-SYN_VL 0006. *See also* Email from Matthew Van Leeuwen (EMC Mortgage Corporation Analyst, Trade Support) to Dylan Hoyt (EMC Mortgage Corporation, Due Diligence Underwriter), dated May 16, 2005, EMC-AMB 001718661 (confirming that the EMC analyst was instructed to revise the loan type to a less risky classification).

[190] Email from Matthew Van Leeuwen (EMC Mortgage Corporation Analyst, Trade Support) to Teri Buhl (author of *More Corruption: Bear Stearns Falsified Information as Raters Shrugged*, The Atlantic, May

138. As a result of the foregoing internal practices and policies, Bear Stearns secretly caused large volumes of loans to be pooled into the Transactions without having undergone anything remotely close to the due diligence review protocols publicly touted to Ambac and investors to solicit their participation in the Transactions. The consequences were and continue to be grave.

2. Bear Stearns Covertly Implemented Policies to Securitize Defective Loans

139. With the knowledge that its due diligence protocols were patently inadequate or simply ignored, Bear Stearns' trading desk devised policies to rid its inventory of the toxic loans EMC had acquired by packaging them into securitizations as quickly as possible – *i.e.*, before a default or delinquency occurred that would render the loans "unsecuritizable." Motivated by the huge short-term gains, Bear Stearns increased its securitization volume and pace by covertly revising its internal policies to securitize those loans before they defaulted, as Bear Stearns fully expected they would. That is, in 2005, Bear Stearns quietly revised its protocols to allow for the securitization of loans before the expiration of the "Early Payment Default," or EPD, period, which it defined as the first 30 to 90 days after the loan is acquired from the originator.

140. Bear Stearns' prior policy was to keep loans in its inventory and "not securitize those loans until the early payment default period ran."[191] Because it had recourse against the suppliers of loans that experienced a missed or delinquent payment shortly after origination, seasoning the loans through the EPD period allowed Bear Stearns to cull out and prevent the

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14, 2010), dated May 13, 2010, EMC-SYN_VL 00034-035 (emphases in original removed, emphasis added).

[191] 12/11/09 Durden Rule 30(b)(6) Deposition Tr. at 178-79 ("Q: And for sub prime loan originations and subprime mortgage loans, was it a practice at EMC to not securitize those loans until the early payment default period ran? A: . . . yes . . . "); *see also id.* at 271 ("I believe that a certain point in time the ordinary target date for securitization for certain assets could have been at the expiration of the EPD protection period as well as additional items that could go into that decision making process.").

securitization of loans likely to "contain some form of misrepresentations and [that] should not have been made."[192] Silverstein explained that EPDs (and first payment defaults, or "FPDs") are indicators of fraud or an inability to pay with respect to a loan, suggesting that the loan never should have been granted in the first instance.[193] The former head of Bear Stearns' Fraud Prevention Group concurred, testifying that an "EPD or FPD is an indicator that there could be a possibility of red flags that could eventually be an indicator of misrep[resentation]."[194]

141. Bear Stearns covertly began securitizing loans before the EPD period ran during 2005,[195] and by the end of 2005, the Bear Stearns' trading desk made that practice the rule. On or about December 2005, Verschleiser ordered Bear Stearns' deal managers and traders to start securitizing all "the subprime loans closed in December for the conduit" by January. Because this directive contravened then-existing policy to "typically hold the conduit loans through EPD protection period," when asked if Verschleiser intended to keep this policy in place, a senior Managing Director from the trading desk immediately confirmed: "No, want to see everything regardless of EPDs."[196]

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[192] Bear Stearns Whole Loan Repurchase Project: Repurchases, Current Processes, dated June 21, 2006, EMC-AMB 004919710-740 at p. 30 ("Loans which become delinquent more than 90+ days in their first year. Although a fraud flag can be raised, many such loans contain some form of misrepresentation and should not have been made.").

[193] 6/4/2007 Silverstein Deposition Tr. at 192. The Collateral Analyst for Mortgage Finance at Bear, Stearns & Co. also confirmed that the existence of an EPD "is an indicator of a borrower's ***unwillingness*** to pay their mortgage." 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 275-76 (emphasis added).

[194] 4/15/2007 Gray Deposition Tr. at 113-14.

[195] 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 272-73 ("[I]n the period of time that EMC has held mortgage loans, I am sure that there are instances of mortgage loans being securitized prior to the expiration of the EPD protection period.").

[196] Email from Chris Scott (Bear, Stearns & Co. Senior Managing Director, Trading) to, among others, Robert Durden (Bear, Stearns & Co. Deal Manager) and Keith Lind (Bear, Stearns & Co. Managing Director, Trading), dated January 3, 2006, EMC-AMB 001385832-833.

142. Bear Stearns strongly enforced the revised policy. On June 13, 2006, Verschleiser said in no uncertain terms that we need "***to be certain we can securitize the loans with 1 month epd before the epd period expires***."[197] When this directive was not applied, Verschleiser angrily demanded explanations as to why loans "were dropped from deals and not securitized before their epd period expired."[198]

143. While recognizing full well that its revised policy materially increased the riskiness of the loans it securitized, Bear Stearns never informed Ambac or any other participant in the securitizations that Bear Stearns "had changed the policy from not securitizing loans before the EPD period had run to securitizing loans while the EPD period had not run."[199]

144. Because large volumes of securitized loans were beginning to experience delinquencies within the EPD period, Bear Stearns issued repurchase claims against the entities from which it purchased the loans (*i.e.*, the originators). Notably, Bear Stearns did not advise those entities that it no longer owned the securitized loans and that Bear Stearns had yet to incur any loss resulting from the default – to the contrary, it had already generated hefty fees from securitizing the loans. Nor did Bear Stearns assert that it was seeking a recovery on behalf of the securitizations through EMC's role as the loan servicer. Rather, Bear Stearns was silent on the ownership status of the loans. But, rather than require these entities to repurchase a loan that it had already sold, which would necessarily require Bear Stearns to repurchase the loan from the

[197] Email from Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk) to Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head of Mortgage Finance), among others, dated June 13, 2006, EMC-AMB 003993365-367.

[198] Email from Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk) to Baron Silverstein and Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Heads of Mortgage Finance), among others, dated March 1, 2007, EMC-AMB 006087607-616.

[199] *See, e.g.*, 12/11/09 Durden Rule 30(b)(6) Deposition Tr. at 273-74 ("In what I've reviewed, I'm not aware of EMC ever disclosing either of those positions to party external to the firm.").

securitization trust, Bear Stearns would "provide alternatives to repurchase of a loan, such as a price adjustment."[200] As discussed below, Bear Stearns presented other alternatives permitting its recovery for EPD claims while accommodating its suppliers such as cash settlements for a fraction of the repurchase price, "downbids," or other credits for future loan purchases.[201]

145. Bear Stearns' claims activities were not limited to loans experiencing an EPD, but included pursuing and settling claims on securitized loans suffering from other issues, such as fraud or underwriting errors. The significance of these recoveries was underscored as early as August 2005 by a Bear Stearns' representative, who stated:

> "It is very important to try to down bid items rather than have First Horizon buy them back. ***That is how we pay for the lights***……."[202]

Bear Stearns' revised EPD policy thus provided another opportunity to further its fraudulent scheme and to doubly profit from its increased securitization of defective loans.

146. Consistent with that view, an internal presentation prepared for and at the request of Tom Marano for just the one-year period between April 2006 and April 2007, stated that Bear Stearns "resolved claims against sellers pertaining to EPDs in the amount of $1.9 billion," and that the "largest percentage of those resolutions were settlements."[203] The Managing Director that oversaw the preparation of the presentation also admitted that "EPDs were the majority . . . of the volumes of claims that EMC Mortgage Corporation submitted against sellers in 2005 and

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[200] *See, e.g.* EMC Claim Form, dated April 6, 2006, EMC-AMB 10534096-98 (claim against Plaza Home Mortgage Financial, Inc. for EPD violation stating "EMC may, at its option, provide alternatives to repurchase of a loan, such as a price adjustment. Please contact your Account Manager if interested.").

[201] *See* Section III.C.6, below.

[202] Email from Brent Giese (Bear, Stearns & Co. Managing Director and Producing Manager of Bear/EMC Correspondent Sales Team) to Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President), dated August 11, 2005, EMC-AMB 007070103-106.

[203] "EPD Summary" Report, EMC-AMB 004099954; 4/26/2010 Golden Deposition Tr. at 255-56.

2006," and pertained to loans that were in Bear Stearns' securitizations.[204] He further confirmed that, through October 31, 2005, Bear Stearns "resolved claims, the majority of which were EPDs, in the amount of $1.7 billion" and, that in 2006, "$2.5 billion in claims were filed, the majority of which were EPDs."[205]

147. Likewise, when reflecting with hindsight on the success of Bear Stearns' claims practices in 2007, the same Managing Director stated that "***filing these claims hasn't won us any popularity contests but it has saved the firm 100's of millions of dollars in the past***."[206] Following his departure from Bear Stearns in June 2008, he then touted on his resume that this process generated $1.25 billion in recoveries.[207]

148. Bear Stearns never "disclosed to Ambac or other investors that it was recovering on EPDs from originators with respect to securitized mortgage loans, pocketing the money and not putting it into the trust."[208] The Managing Director of Bear Stearns' quality control, claims and representation and warranty departments also could not identify any instance where it "disclosed to Ambac or any other monoline insurer the number of claims with respect to EPDs filed in 2005 and 2006 and thereafter [or] the volume of those claims that were settled in 2006."[209] To the contrary, to perpetuate these recoveries and conceal loans that it knew raised

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[204] 4/26/2010 Golden Deposition Tr. at 120-21.

[205] 4/26/2010 Golden Deposition Tr. at 141.

[206] Email from Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President) to, among others, Leslie Rodriguez (EMC Residential Mortgage Managing Director) and Whitney Long (EMC Residential Mortgage, Vice President of Risk Management and Claims), dated September 15, 2007, EMC-AMB 06870106-110.

[207] 4/26/10 Golden Deposition Exh. 1.

[208] 12/11/2009 Durden Rule 30(b)(6) Deposition Tr. at 269 ("Q. Well, sitting here today, you can't identify any instance in which EMC or Bear Stearns disclosed to Ambac or other investors that it was recovering on EPDs from originators with respect to securitized mortgage loans, pocketing the money and not putting it into the trust, right? . . . A. Yeah, I'm not aware of a disclosure to Ambac.").

[209] 4/26/2010 Golden Deposition Tr. at 144-45.

"red flags" of fraud and other defects, the manager of repurchase operations admitted that when Bear Stearns recovered on an EPD claim it "would not evaluate the reps and warranties it gave on that very same loan to securitization participants to assess whether there might be other breaches of reps and warranties other than an EPD breach."[210]

149. With this motivation and in view of the substantial recoveries it was able to generate, Bear Stearns then devoted its post-securitization efforts to identifying opportunities to generate recoveries and other benefits from the sellers and originators that supplied ever-growing numbers of defective loans backing its securitizations.

3. Bear Stearns' Quality Control and Repurchase Practices Furthered Its Scheme to the Detriment of the Securitizations

150. As discussed above, Bear Stearns represented to Ambac, rating agencies and potential investors that the securitization participants would benefit from Bear Stearns' "quality control" operations, which re-underwrote loans "post settlement" or *after* Bear Stearns purchased and securitized those loans.[211] Bear Stearns' quality control operations comprised a "production" review undertaken on a randomly selected sample of all loans EMC acquired each month, as well as a comprehensive review of loans that Bear Stearns purchased from new sellers and loans that defaulted within the first year.[212] Bear Stearns reviewed "sample queries of

[210] 1/22/2010 Megha Rule 30(b)(6) Deposition Tr. at 94-95. *See also* 2/3/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 455 (noting that prior to 2007 when its counsel directed Bear Stearns to change its wrongful practices, "to the extent that EMC obtained a settlement on an EPD claim, it had not subject[ed] those loans to a separate rep and warranty review").

[211] *See* Marketing Decks distributed to Ambac and other potential participants (stating that quality control is a "Post Settlement" review, which includes a "[c]onduit team dedicated to claims of breaches of reps and warrants discovered by the Quality Control group investigations."), discussed in Section III.B.1, above; *see also* 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 179 (confirming that due diligence "was done prior to the settlement of the purchase of the loans, whereas, the quality control reviews were done after EMC settled the purchase of the – of the loan."); 4/26/2010 Golden Deposition Tr. at 17 (confirming that quality control refers to the "post-purchase review of loans that EMC and Bear Stearns securitized").

[212] 4/26/2010 Golden Deposition Tr. at 208-209.

production [to] determine if . . . the underwriter was doing their job and if it was underwritten correctly or there was any defect in the loan."[213] According to Bear Stearns, its quality control department also was responsible for determining whether defective loans complied with the representations and warranties EMC made to Ambac and other securitization participants in the deal documents (referred to as a "securitization breach review").[214]

151. Bear Stearns' commitments to review, identify, and flush out defective loans found after securitization were material to Ambac's participation in the Transactions.[215] Despite marketing its quality control operations for the benefit of Ambac and investors, however, Bear Stearns never disclosed, and deliberately concealed, that its quality control practices were dedicated exclusively to securing for Bear Stearns additional consideration from the entities that supplied Bear Stearns with the toxic loans – to the detriment of the securitizations that were left with the massive risks and losses on the loans.[216] That is, when a securitized loan defaulted

[213] 1/22/2010 Megha Rule 30(b)(6) Deposition Tr. at 127. Internal policy documents also establish that Bear Stearns viewed the randomly selected loan samples to provide "the basis for statistical inference (i.e. generalizing from sampled findings to the overall population)," and "[a]s such, they are the most important sample group." *See* EMC's Quality Control Review Guidelines attached to the Contractor Services Agreement between EMC and Adfitech, dated January 26, 2005, EMC-AMB 000229896-918 at 910; 5/20/2010 Serrano Deposition Tr. at 25-27 (acknowledging that "the random sample would be representative of the pool that was purchased that month").

[214] 4/26/2010 Golden Deposition Tr. at 59-60 ("[T]he person who were [sic] QC'ing the loans then made a determination on whether or not it was a securitization breach. . . it was actually the individual who reviewed the loan did the original QC."); *see also* 2/3/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 485 (as of December 2005, the department that "reviewed mortgage loans to assess whether or not the loans were in breach of a representation or warranty given by EMC to participants in a securitization," was "done by the quality control department").

[215] March 26, 2007 notes from Gary Gal (Ambac Vice President, MBS Department of Structured Finance) concerning Bear Stearns due diligence call with Cheryl Glory (Bear, Stearns & Co. Managing Director, Mortgage Finance), Soung Ho Park (Bear, Stearns & Co. Analyst, Mortgage Finance) and Jamie Moy (Bear, Stearns & Co., Mortgage Finance), ABK-EMC03212692 ("When loans goes [sic] delinquent they have external and internal reviewers do a full re-underwrite."). *See also* 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 156-57.

[216] As Mary Haggerty confirmed, when quality control uncovered defective loans, "the first process is the seller has an opportunity to rebut it, provide additional information, et cetera, to see if it could be cured," and if the defect could not be cured, "the claims department would typically issue a repurchase demand to

during the EPD period or Bear Stearns identified a breach in a representation made *to* EMC, Bear Stearns would attempt to negotiate a settlement with the supplier of the loan, and would pocket the recovery. Bear Stearns deliberately decided not to review the defaulted or defective loans identified during quality control for breaches of representations made *by* EMC unless the suppliers demanded to repurchase the loans (and tendered the repurchase funds to EMC) in lieu of settling, an approach the suppliers rarely took (and had little incentive to take) as it was the more costly alternative from their perspective.

152. Reflecting its decision *not* to review defective loans for securitization breaches, Bear Stearns' quality control manager confirmed that until late 2007 there were no "protocols in place to assess securitization breaches with respect to loans acquired through the bulk and flow conduit" (which was the source of the vast majority of mortgage loans at issue).[217] Before then, Bear Stearns limited the securitization breach review to circumstances in which "the seller has already agreed to purchase these loans and then we need to find a reason on these loans to purchase it out of security."[218] In other words, Bear Stearns simply ignored EMC's express representations and warranties requiring prompt disclosure of breaching loans irrespective of Bear Stearns' claims against the sellers of those loans.[219]

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the seller if there was a breach of the a rep and warranty." 2/3/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 464, 476-77. No securitization breach was commenced at that time.

[217] 5/20/2010 Serrano Deposition Tr. at 47; *id.* at 44 (noting that as of September 2006, Bear Stearns' securitization breach review "was not something that was executed correctly").

[218] EMC-AMB 010726678. The policies in place as of January 2007 for "reviewing loans for breaches," also provide "[o]nce the lender has confirmed that the they are going to repurchase the loans, it is necessary to buy the loan out of a security if in a deal," EMC-AMB 009649870-076.

[219] *See* Section V.C.1, below.

153. Consequently, despite the substantial number of EPD claims Bear Stearns asserted against the suppliers of the securitized loans,[220] its quality control operations generally did not review those loans for securitization breaches. A Bear Stearns quality control manager revealed Bear Stearns' reasoning: "I don't think we want to do anything with EPDs separate from the 90 Day DQs that are done in the 90 Day DQ shell because ***if we end up keeping the loan we don't want to find a PSA breach***, right?"[221] (The "PSA" is the document in which EMC *made* representations and warranties to the securitizations.) So Bear Stearns deliberately avoided conducting securitization breach reviews for defaulted or defective loans because it did not want to document the breaches it knew existed.

154. The percentage of defective loans Bear Stearns identified through its quality control sampling review was substantial. Bear Stearns contracted with Adfitech, Inc. ("Adfitech") to perform the quality control reviews on its behalf,[222] and instructed Adfitech that the purpose of quality control is "to review loans to evaluate if they meet investor quality guidelines, if sound underwriting judgment was used, and if the loan is devoid of all misrepresentation or fraud characteristics."[223] With this as its directive, Adfitech conducted

[220] *See* Section III.C.2, above.

[221] Email from Tamara Jewell (EMC Residential Mortgage, Project Manager) to Robert Glenny (EMC Residential Mortgage, Analytics Group/Seller Approval) and Randy Deschenes (EMC Residential Mortgage, CEO), dated July 30, 2007, EMC-AMB 009526626-627.

[222] 5/20/2010 Serrano Deposition Tr. at 22-23 ("Adfitech undertook all the monthly sampling quality control review of loans for the bulk and flow channel of EMC.").

[223] Contractor Services Agreement between EMC and Adfitech, dated January 26, 2005, EMC-AMB 000229896-918 at 909. Bear Stearns reinforced these protocols with Adfitech in its "Loan Origination Quality Control Policy as of February 2007, which expressly stated that the purpose of quality control was to, among other things, "assure that all loans . . . comply with insurer and guarantor requirements," and also called for Bear Stearns to "report to the investor or government agency any violation of law or regulation, false statements, material defect or program abuses within 30 days of discovery." Email from Greg Anderson (Adfitech quality control supervisor) to Sherrie Dobbins (EMC Mortgage Corporation Assistant Manager, Quality Control Underwriting and Vendor Management) and Fernando Serrano (EMC

quality review of samples of loans Bear Stearns acquired. For the period through the end of 2006, Adfitech performed quality control reviews of loans in the Transactions and found that ***38.8%*** to be defective based on Bear Stearns' quality control guidelines. Although these findings revealed material information about the riskiness of loans, and breaches of EMC's representations and warranties (discussed below),[224] at no time before or after the Transactions did Bear Stearns disclose these remarkably high defect rates.

155. Instead, to further its fraudulent scheme and benefit from the securitization of defective loans, Bear Stearns relied on its quality control operations to assert repurchase claims against the entities from which it purchased the loans. Bear Stearns pursued and settled claims against the loan suppliers on the basis that the loans were "not eligible for delivery" without disclosing that it already had sold the loans into a securitization.[225] The discovery of Bear Stearns' files have revealed, to date, almost 4,000 loans in the Transactions for which Bear Stearns made claims against originators but did not repurchase from securitizations.[226] Bear Stearns never disclosed to Ambac or investors that, as demonstrated by its own conduct, these loan were defective.

Mortgage Corp., Quality Control Manager), dated February 2, 2007, EMC-AMB 006975253-267 at 255, 261.

[224] Effectively conceding that the Adfitech quality control findings evidenced securitization breaches, Bear Stearns' Senior Managing Director of the quality control department confirmed that between 2005 through 2006 it applied the same criteria for both of those analyses. 4/26/2010 Golden Deposition Tr. at 104-105.

[225] Bear Stearns' claims correspondence shows that EMC asserted claims against sellers with respect to loans that it had previously securitized in the Transactions on the grounds that "loan was not eligible for delivery to EMC." *See, e.g.*, EMC's claim correspondence to American Home Mortgage, dated November 20, 2006, EMC-AMB 004922387 (claim made with respect to four loans previously sold into the SACO 2006-2 Transaction); EMC's claim correspondence to SunTrust Mortgage, dated April 11, 2008, STM-00004433-434 (claim made with respect to one loan previously sold into the BSSLT Transaction).

[226] *See* Whole Loan Inventory Tracking System ("WITS") Database, EMC-AMB 002768454; LMS Database, EMC-AMB1 000007558.

156. By concealing the true nature of its quality control operations and conditioning the securitization breach process on its ability to first recover repurchase funds for itself, Bear Stearns deceived the securitization participants and intentionally interfered with and frustrated EMC's contractual promises to Ambac and investors that it would "promptly" disclose – and within 90 days, cure, substitute, or repurchase – breaching loans from the securitization trusts.

4. The Sheer Magnitude of Defective Loans Bear Stearns Securitized Overwhelmed Its Quality Control and Repurchase Protocols

157. By at least 2006, Bear Stearns had acquired and securitized so many defective and toxic loans that its quality control and claims departments became so overwhelmed that it was unable to process its claims against the entities from which it purchased the loans feeding into its securitization pipeline.

158. The Senior Managing Director at Bear, Stearns & Co. in charge of these departments confirmed being "overwhelmed" by the sheer magnitude of claims it had to file, which had escalated in parallel with Bear Stearns' "rapid increase in the amount loans being purchased and securitized."[227]

159. An internal audit report issued on February 28, 2006 and distributed to senior executives including Haggerty, Cayne, Marano, Mayer, Schwartz, and Spector[228] also confirms Bear Stearns' inability to process its claims, identifying "a significant backlog for collecting from and submitting claims to sellers" consisting of at least 9,000 outstanding claims worth over

[227] 4/26/2010 Golden Deposition Tr. at 119-20.

[228] Email from Stephanie Paduano (Bear, Stearns & Co. Internal Audit Department) dated March 7, 2006, EMC-AMB 001496304.

$720 million, and concluding that the procedures in place to process, collect, resolve, and monitor such claims were inadequate or simply non-existent.[229]

160. Despite directing the Senior Managing Director to establish appropriate claims procedures and enhance existing protocols, less than two months later Verschleiser and Haggerty agreed that the "[c]laims situation continues to be a disaster – hitting crisis," because "our operation cannot support the claims collection methodology we have been trying to pursue," and that the Senior Managing Director "clearly continues to be overwhelmed and this is really hurting."[230] Indeed, internal audit reports issued on September 22, 2006 and February 26, 2007 continued to report that many of the issues previously identified in need of correction in early 2006 had yet to be addressed.[231]

161. No one at Bear Stearns disclosed to Ambac that it had acquired and securitized so many defective loans, requiring vast numbers of claims against originators that its internal departments could not handle the workload. The defective loans that Bear Stearns' understaffed departments were able to identify and file claims for represent just a small fraction of the total defective loans that were securitized and would have been identified if the departments had been staffed adequately.

[229] EMC-AMB 001496305-EMC-AMB 001496311, "Bear Stearns Internal Audit Report – EMC Mortgage Corporation ('EMC') – Review of Representations and Warrants Department."

[230] Emails from Mary Haggerty (Bear, Stearns & Co. Senior Managing Directors, Co-Head Mortgage Finanace) to Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk), dated April 18 and April 12, 2006, EMC-AMB 001498898-899.

[231] September 22, 2006 Internal Audit (EMC-AMB 010858575-576) and February 26, 2007 Internal Audit (EMC-AMB 010858610-613), each titled, "Status of Unresolved Audit Report Issues for EMC Mortgage Corporation ("EMC") – Review of Representations and Warrants Department."

5. Bear Stearns Failed to Disclose That Its Counsel and Outside Auditors Found Its Claims Practices Contravened Its Contractual Provisions, Investors' Expectations, and Industry Standards

162. By mid-2006, the growing backlog of repurchase claims had risen to alarming levels, drawing the attention of its external auditors and counsel, which in no uncertain terms issued stern warnings instructing Bear Stearns to revise its claims practices.

163. In August 2006, Bear Stearns' external auditor, PriceWaterhouseCoopers ("PWC"), advised Bear Stearns that its failure to promptly review the loans identified as defaulting or defective was a breach of its obligations to the securitizations.[232] PWC advised Bear Stearns to begin the "[i]mmediate processing of the buy-out if there is a clear breach in the PSA agreement to match common industry practices, the expectation of investors and to comply with the provisions in the PSA agreement."[233] PWC explained that the effect of its proposal "in the Claims work processing flow, is to effectively reverse the current processing order by first considering whether there is a breach of representations and warranties in the PSA agreement and then pursue the claim against the original seller of the loan."[234] The auditor further advised Bear Stearns to promptly remedy its "[l]ack of repurchase related policies and procedures in the Claims, G/L Control and Investor Accounting departments" to comply with SEC regulations.[235]

164. Shortly thereafter, Bear Stearns' legal counsel reinforced PWC's assessment and advised Bear Stearns that it had to revise its improper practices. Haggerty confirmed that, in

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[232] *See* EMC-AMB 006803201-277, "UPB Break Repurchase Project – August 31, 2006."

[233] *Id.* at p. 21.

[234] *Id.* at p. 26.

[235] *See id.* at p. 26 (making reference to Regulation AB, effective January 1, 2006). PWC also recommended that Bear Stearns stop asserting EPD claims to sellers on securitized loans because "an early payment default would not be sufficient cause to buy-back the loan from the security holder. . . . [and] that [Bear Stearns] is processing put-back requests for loans that may not be required to be repurchased out of the security trusts." *See id.* at p. 26. In other words, PWC recognized the incongruity and impropriety of Bear Stearns submitting repurchase demands to suppliers for loans it did not own (*i.e.*, were in the securitizations), but yet had no intention of repurchasing from the securitizations.

early 2007, its counsel advised Bear Stearns that it could no longer keep for itself the substantial monetary recoveries obtained on its EPD and other claims relating to securitized loans, and moreover, that it was required to review the loans for which it obtained recoveries to assess whether the loans breached EMC's representations and warranties made in its securitizations.[236]

165. This legal advice was a recognition, and an admission, that Bear Stearns (i) was not complying with its obligation to review the defaulting or defective loans for which it made claims against suppliers to determine whether they breached representations and warranties EMC extended in the securitization, and (ii) improperly was retaining recoveries on those loans that should be contributed to the securitizations.[237] Indeed, as of August 2006, there were no procedures in place for reviewing the loans subject to settlement agreements or tracking the funds recovered, causing one Bear Stearns employee to admit to "making it up as I go…scary!"[238] Bear, Stearns & Co.'s Executive Director and Assistant General Counsel also confirmed that, before its Legal Department intervened in 2007, no documentation existed setting forth the protocol for disclosing securitization breaches to investors or insurers, such as Ambac.[239] Bear Stearns concealed these issues from Ambac and other securitization participants.

166. Contrary to its own counsel's advice, Bear Stearns did not implement a policy to review promptly defective or defaulted loans for securitization breaches until at least September 2007, long after the last Transaction and only after the defaults on its securities began to rise

[236] 2/3/2010 Haggerty Rule 30(b)(6) Deposition Tr. 455-63, 510.

[237] 2/3/2010 Haggerty Rule 30(b)(6) Deposition Tr. 510; 4/19/2010 Glory Deposition Tr. 125.

[238] Email from Whitney Long (EMC Residential Mortgage, Vice President of Risk Management and Claims) to Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President), dated August 12, 2006, EMC-AMB 010787527-31.

[239] 1/7/2010 Mesuk Rule 30(b)(6) Deposition Tr. at 115-18.

sharply.[240] According to its employees, moreover, Bear Stearns still has not fully implemented its counsel's advice to contribute to the securitizations the recoveries it obtained on the securitized loans.[241]

167. Instead of promptly making the requisite disclosures and undertaking the appropriate cures, Bear Stearns disregarded the advice given to it and continued to conceal the true nature of its internal operations to induce participation in subsequent transactions, including the SACO 2006-8 and BSSLT 2007-1 Transactions. Bear Stearns also developed ongoing measures to obscure the magnitude of defective loans in its securitizations, and continued to offer concessions designed to maintain its flow of loans from the suppliers of the defective loans.

6. Bear Stearns Made Accommodations to Sellers to Conceal the Volume of Defective Loans and Maintain the Flow of Loans from Those Sellers

168. To perpetuate its fraudulent scheme, Bear Stearns quickly moved to reduce the outstanding claims against the entities from which it purchased the securitized loans by offering them substantial concessions and other accommodations as an alternative to repurchase, which would keep its suppliers happy and ensure the continued flow of loans from these entities available for Bear Stearns to package and bundle in future securitization deals. At the same time, Bear Stearns still managed to secure for itself massive cash recoveries and other benefits on account of toxic loans that it long ago packaged into a securitization.

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[240] *See* Section III.D., below. *See also* E-mail from Whitney Long (EMC Residential Mortgage, Vice President of Risk Management and Claims) to, among others, Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President) and Leslie Rodriguez (EMC Residential Mortgage Managing Director), dated September 13, 2007, EMC-AMB 007176791-800 at 793-94.

[241] 4/19/2010 Glory Deposition Tr. 41 (process not complete as of her departure in Spring 2009); 4/26/2010 Golden Deposition Tr. 142-43 (the policy not fully implemented before he left in Spring 2008). *See also* Email from Cheryl Glory (Bear, Stearns & Co. Managing Director, Mortgage Finance) to Mary Haggerty (Bear, Stearns & Co. Senior Managing Directors, Co-Head Mortgage Finanace) and John Horner (J.P. Morgan Managing Director, Co-Head of Agency and Non-Agency Trading), dated November 20, 2008, EMC-AMB 011045262-266 at 265 (discussing "***phase I*** of the settlement funds allocation methodology" as part of the Investor Relations Group's ongoing projects) (emphasis added).

169. Although these entities were contractually obligated to buy back defective loans at an agreed-upon repurchase price, by extending more favorable alternatives Bear Stearns could recover an economic benefit from these entities without having to first repurchase defective loans out of a securitization. Moreover, the Senior Managing Director responsible for the claims department confirmed that before offering alternatives to the repurchase of loans that had been securitized, Bear Stearns did not seek the approval or consent of the securitization trust.[242] Indeed, had it done so, Bear Stearns would have alerted the securitization participants to the steadily growing number of loans plagued by material underwriting failures and other fraudulent activities.

170. Accordingly, through EMC, Bear Stearns entered into confidential settlement agreements resolving EPD and other claims in exchange for cash payments at a fraction of the repurchase price "***in lieu of repurchasing the defective loans***."[243] In other instances, Bear Stearns accommodated originators by agreeing to (i) cancel or waive the claims entirely,[244] or (ii) create "reserve programs" that allowed it to use funds from these entities for EPDs violations and other defects by applying them toward future loan purchases. [245] Each of these alternatives

[242] 4/26/2010 Golden Deposition Tr. at 148.

[243] *See* Section III.F, below.

[244] *See* Emails from Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finanace), dated April 18 and April 12, 2006, EMC-AMB 001498898-899 (Haggerty recommends the "immediate cancel of EPD claims for loans that are in deals and are current" after "First Horizon traded a deal away that [EMC] had a 2 tic better bid because [EMC's] EPD claims with them is significantly more than market"); *see also* Email from Brent Giese (Bear, Stearns & Co. Managing Director and Producing Manager of Bear/EMC Correspondent Sales Team), dated February 17, 2005, EMC-AMB 002551279-282 at 279 (noting that originators were complaining about the prevalence of EMC's EPD claims and stating that "at some point will penalize Bear/EMC in terms of not executing business with us if the issues continue").

[245] *See* Email from Paul Nagai (EMC), dated August 7, 2006, EMC-AMB 003637057-058 (The email chain concerns a "new seller claims reserve program being instituted to support sellers with outstanding claims." It states that "This program will allow sellers that have outstanding claims to continue their production activities with Bear Stearns / EMC . . . ."); *see also* 12/11/2009 Durden Rule 30(b)(6)

afforded incremental consideration to Bear Stearns for toxic loans it had already sold to and that remained in the securitization, while at the same time keeping its suppliers happy so as to maintain loan production for inclusion in subsequent securitizations.

171. The limited documentation secured from Bear Stearns to date reveals that it asserted claims against originators for large volumes of defective loans in its securitizations. For example, one report prepared by JP Morgan as late as 2009, lists $575 million worth of loans – including loans in the Transactions – that Bear Stearns put back to originators, ***but did not repurchase from the securitizations.*** Rather, Bear Stearns entered into confidential settlement agreements with the originators to resolve its claims in exchange for monetary payments for just a small fraction (20%) of the total value of the repurchase claims.

172. Bear Stearns did not contemporaneously disclose its practices, or the significant funds it recovered. Instead, breaching loans remained in the trusts and caused continued losses to Ambac and other participants in Bear Stearns' securitizations. EMC initially refused to disclose those agreements in connection with litigation concerning the very loans in dispute here on the grounds that (i) "payments made by sellers to EMC pursuant to the settlement agreements were on a 'lump-sum' basis, without repurchase of any loans, and without allocation of specific amounts to any loans," and (ii) those agreements did not "provide for admissions of liability or substantive resolution of any repurchase claims, apart from simply settling claims relating to populations of loans."[246] EMC's position confirms that settlements were structured in such a way to obfuscate the basis and amounts of the settlement with respective to the particular loans found to be defective. Thus, having deliberately securitized loans it knew represented a high risk

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Deposition Tr. at 290 ("Q. Do you recall that this program was put in place as an accommodation to sellers with large claims so that EMC could continue to collect and obtain mortgage loans from those originators? A. From the language of the Email, it does appear so.").

[246] Letter from EMC's counsel to Ambac's counsel, dated November 6, 2009.

of default or other material failings, Bear Stearns covertly generated significant economic benefits for itself at the expense of Ambac, the Note Purchasers, and other securitization participants.

173. As an accommodation to its suppliers, and to reduce the outstanding claims, Bear Stearns also agreed to allow loans that defaulted during the EPD period, then starting paying again, to remain in its securitization by extending the EPD period.[247] Notably, Bear Stearns' policy allowed it to extend EPD claims against originators with respect to only securitized loans, and expressly forbade such extensions for loans in Bear Stearns' own inventory. Bear Stearns did not want such loans in its inventory because it knew loans that missed payments within the EPD period were very risky and likely to default.[248] In the words of the head of Bear Stearns' quality control department, "the trading desk didn't want to own loans in inventory that had an EPD."[249] So "if the loan was in inventory, an extension agreement wasn't an option" and "the seller had to either repurchase or settle the claim."[250] The differing treatment of loans subject to an EPD illustrates the full extent of Bear Stearns' duplicitous scheme. Even though EPDs raise "red flags" of fraud or other substantive issues causing a borrower to default on his or her initial mortgage payments, Bear Stearns furthered its scheme by quietly agreeing to defer the EPD claim in exchange for other benefits from the loan originator.

[247] Bear Stearns' policy for extending claims states that "Only loans filed as EPD claims can be considered for an extension. In order for an extension, a loan must be securitized." Email and attachments from Pat Moore (EMC Manager, Representations and Warranties Department) to William Glasgow (EMC Executive Vice President, Loan Administrative Division), dated January 7, 2007, EMC-AMB 009650340-359 at 344.

[248] 6/4/2007 Silverstein Deposition Tr. at 192. *See also* Section III.C.2, above.

[249] 4/26/2010 Golden Deposition Tr. at 151-57.

[250] *Id.*

174. As previewed earlier in connection with its EPD recoveries, Bear Stearns generated billions of dollars in recoveries through these activities. Bear Stearns' internal audit report issued on February 26, 2007 shows that in 2006, Bear Stearns (i) resolved "$1.7 billion of claims, an increase of over 227% from the previous year," and (ii) filed $2.5 billion in claims against the entities originating and selling it defective loans "reflecting an increase of 78% from the prior year."[251]

175. By continuing to offer less expensive alternatives in lieu of an actual loan repurchase through 2007, Bear Stearns generated additional recoveries and benefits in violation of its obligations to review, disclose or repurchase breaching loans from its securitizations.[252] And, by concealing the large volumes of defective loans and keeping the recoveries generated from its undisclosed settlements with originators for itself, Bear Stearns had no economic incentive to honor its securitization practices because then it would have to use its own funds to pay the difference between the repurchase price and the settlement without recourse against the originator. Taking full advantage of this scam, Bear Stearns was able to pocket hundreds of millions of dollars for itself. In 2007 and through the first quarter of 2008, Bear Stearns resolved claims representing $1.3 billion of unpaid principal balance through settlements or other consideration, which provided over $367 million of "economic value that was recovered from

[251] Bear Stearns Internal Audit Department Escalation Memorandum, titled, "Status of Unresolved Audit Report Issues for EMC Mortgage Corporation ("EMC") – Review of Representations and Warrants Department," dated February 26, 2007, EMC-AMB 010858610-613 at 611.

[252] *See* Email from Whitney Long (EMC Residential Mortgage, Vice President of Risk Management and Claims) to Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President), dated July 27, 2007, EMC-AMB 006736165-172 (offering "amnesty program" to suspended or terminated sellers by "forgiving claims in exchange for loan production" at reduced pricing); Email from Sharrell Atkins (EMC Mortgage Corp. Assistant Manager, Specialized Fraud Review) to Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President), dated August 27, 2007, EMC-AMB 006870833 – 834 (extending claim concerning fraud because "SunTrust is an active seller . . . we have issued a 12 month extension").

the sellers."[253] As importantly, it thus continued to foster and financially reward the same type of abysmal origination practices by its sellers that resulted in these defective loans.

7. Bear Stearns Did Not Disclose that It Was Clearing Out Its Inventory by Securitizing Defective Loans While Concealing Its True Assessment of the Securitized Loans

176. Bear Stearns employees were well aware of the poor quality of the loans that were being pooled into its securitizations. Indeed, in August 2006 – one month before the closing date – the deal manager responsible for SACO 2006-8, Nick Smith, referred to the Transaction as a "SACK OF SHIT."[254] Likewise, in earlier correspondence with the Managing Director of the trading desk at Bear, Stearns & Co., this same deal manager characterized the SACO 2006-8 Transaction as a "shitbreather."[255] Not surprisingly, Bear Stearns did not disclose this widespread internal acknowledgment of the poor quality of the loans it was securitizing to investors or Ambac.

177. Moreover, no one at Bear Stearns responded to Nick Smith to correct his characterization of the Bear Stearns' collateral – nor could they, given that they knew the true magnitude of defective loans it intended to securitize. For example, less than two months earlier, an internal review of the loans acquired from American Home Mortgage revealed that less than 22.85% of the loans were current, while up to 60% of the loans had experienced delinquencies of

[253] 4/26/2010 Golden Deposition Tr. at 63-65 (explaining Bear Stearns' Risk Management Division Report, EMC-AMB 010775342-407).

[254] Email from Nicholas Smith (Bear, Stearns & Co. Vice President, Deal Manager of the SACO 2006-8 Transaction) to Keith Lind (Bear, Stearns & Co. Managing Director, Trading), dated August 12, 2006, EMC-AMB 004377399-400.

[255] Email from Nicholas Smith (Bear, Stearns & Co. Vice President, Deal Manager of the SACO 2006-8 Transaction) to Keith Lind (Bear, Stearns & Co. Managing Director, Trading), dated July 11, 2006, EMC-AMB 002326075-077. In an attempt to explain Smith's characterization of the deal, on direct examination at the June 2, 2010 deposition, Smith incredulously testified that he uses the term "shitbreather" as a "term of endearment." 6/2/2010 Smith Deposition Tr. 211.

30 days or greater (13% were delinquent for longer than 120 days).[256] Rather than disclose this remarkably poor performance, Bear Stearns funneled over 1,600 American Home Mortgage loans into the SACO 2006-8 Transaction, making it the principal originator in the Transaction responsible for the origination of over 30% of the loan pool. Also in advance of the SACO 2006-8 Transaction, Nick Smith and the Bear, Stearns & Co. Managing Director of the trading desk joked about the poor quality of the loans acquired from Just Mortgage, another originator whose operations Bear Stearns financed.[257] Instead of disclosing its true perspective on the loans, Bear Stearns packaged and sold over 1,000 Just Mortgage loans – or just over 19% of the SACO 2006-8 loan pool – when the deal closed a few months later in September.[258]

178. By the start of 2007, to downplay the impact of the deteriorating performance of its prior securitizations in order to keep issuing new ones, Bear Stearns began publicly touting its efforts to improve the quality the loans it was securitizing by (i) "tightening" underwriting standards, in many respects to "emphasize" the controls that it should have had in place all along and (ii) "downgrading' originators within its network consistently selling the worst performing loans to "suspended" or "terminated" status as a means to prevent and limit the securitization of loans from those third parties. To this end, in March 2007, Bear Stearns employees informed

[256] Email from Judy Duffek (EMC Mortgage Corporation Associate Vice President, Seller Review & Approval) to Randy Deschenes (EMC Residential Mortgage CEO and Managing Director), EMC-AMB 006740876-877 at 877 (recommending that Bear Stearns "discontinue purchase of 2nd liens from this client or bid to miss since this seems to be the product that they have the most problem with which are not returning value.").

[257] Email from Nicholas Smith (Bear, Stearns & Co. Vice President, Deal Manager for SACO 2006-8) to Keith Lind (Bear, Stearns & Co. Managing Director, Trading), dated June 30 2006, EMC-AMB 002319215-216 (sarcastically asserting that "Everyone loves their loans"). *See also* Email from Nicholas Smith to Keith Lind, dated June 29 2006, EMC-AMB 002317084-085 (noting that another insurer would not participate "even if we pull the Just Mtg. Population").

[258] Reflecting the issues with the Just Mortgage loans, in the email chain in which he referred to the 2006-8 Transaction as a "shit breather", Nick Smith specifically highlighted for Keith Lind and Silverstein that the pool would be "including the Just Mtg population." Email from Nicholas Smith to Keith Lind, dated July 11, 2006, EMC-AMB 002326075-077 at 075.

Ambac that "there has been significant improvement in the collateral pool itself [for BSSLT 2007-1],"[259] and pushed Ambac's credit underwriters to speak with Verschleiser to discuss the "originators and correspondents we actually kicked out of the program, which should also be a major difference."[260]

179. Bear Stearns knew quite well – but did not disclose – that its inventory still was overridden with defective loans purchased from the worst performing originators in its network.[261] Rather than accept the consequences of having already purchased these loans through its own bad processes and procedures, Bear Stearns unilaterally decided to ***stop performing post-purchase quality control on loans purchased from suspended or terminated sellers*** to buy time for its trading desk to clear out its pipeline of defective loans.[262]

180. Bear Stearns changed this policy without informing the participants in its securitizations. Although its securitizations, including the SACO Transactions, were filled with loans purchased from terminated or suspended sellers, Bear Stearns did not disclose its decision to discontinue the seller monitoring and quality control operations it represented it would

[259] Email from Darryl Smith (Bear, Stearns & Co., Fixed Income Structured Credit Sales, Securitization Side) to Patrick McCormick (Ambac First Vice President, MBS Department of Structured Finance), dated March 30, 2007, ABK-EMC01536356.

[260] Email from Darryl Smith (Bear, Stearns & Co., Fixed Income Structured Credit Sales, Securitization Side) to Patrick McCormick (Ambac First Vice President, MBS Department of Structured Finance), dated March 30, 2007, ABK-EMC01536369-370.

[261] *See, e.g.*, Bear Stearns' seller "Watch List" as of February 27, 2007, EMC-AMB 005042831-839 at 837 (identifying at least 48 sellers with "D" of "F" grades that originated at least 1,680 loans later securitized in the BSSLT 2007-1 Transaction); Email from Julio Chong (EMC Mortgage Corp., Business Information) dated March 28, 2007, EMC-AMB 010346044-045 (identifying over 40 "high risk" sellers "to be cut off by 3/30/07" based on high loss severity in securitized loans, 20 of which originated over 2,800 loans later securitized in the BSSLT 2007-1 Transaction).

[262] 5/20/2010 Serrano Deposition Tr. 180-184; E-mail from Norton Wells (EMC Mortgage Corp. Executive Vice President, Quality Control) to, among others, Mary Haggerty (Bear, Stearns & Co. Senior Managing Director, Co-Head Mortgage Finanace), Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President), and Fernando Serrano (EMC Mortgage Corp., Quality Control Manager), dated April 18, 2007, EMC-AMB 006009144-145 ("Loans from these [Terminated, Suspended and "F" rated] Sellers are being excluded from sampling per instructions.").

undertake. Rather, in advance of the BSSLT Transaction, which closed on April 30, 2007, Bear Stearns disseminated to Ambac marketing decks that continued to tout its seller monitoring and quality control operations to induce Ambac's participation in the BSSLT Transaction.[263]

181. Bear Stearns thus rid its inventory of the very loans it knew represented a high risk of default or other material failing by passing them on to investors and insurers, such as Ambac, by means of its false and misleading representations. Bear Stearns knowingly funneled into the BSSLT Transaction large volumes of loans from originators that it previously had deemed as "high risk" sellers and that it had downgraded to "suspended" or "terminated" status with "F" or "D" ratings due to "material weakness in credit quality and/or collateral quality."[264]

182. Consistent with this conduct but contrary to its contemporaneous disclosures to Ambac, internally Bear Stearns employees more aptly characterized the BSSLT 2007-1 Transaction as a "going out of business sale."[265] Another called it a "DOG."[266] Both characterizations were correct, but neither was disclosed.

183. The Bear Stearns trading desk placed great pressure on the other departments to quickly purge its inventory of the loans that it knew represented greater likelihood of not performing due to serious defects in their origination. If the defective loans were not securitized,

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[263] Email from Soung Ho Park (Bear, Stearns & Co. Analyst, Mortgage Finance) to Hartmut Ott (Ambac Vice President, MBS Department of Structured Finance), dated March 22, 2007, ABK-EMC01555076-269, discussed in Section III.B.1, above.

[264] Bear Stearns' Seller Monitoring Report as of January 7, 2008 reflects that Bear Stearns downgraded SouthStar as of April 2, 2007, but then pushed through nearly 1,500 loans into the BSSLT 2007-2 Transaction making SouthStar the third largest originator in that deal. *See* EMC-AMB 010909740 (also showing that Bear Stearns securitized over 208 and 158 loans in the BSSLT 2007-1 Transaction that it had acquired from Steward Financial Inc. and First Residential Mortgage Services Corporation, respectively, despite previously downgrading them to "F" ratings).

[265] Email from Charles Mehl (Bear, Stearns & Co. Analyst, Mortgage Finance) to Keith Lind (Bear, Stearns & Co. Managing Director, Trading), dated April 5, 2007, EMC-AMB 002075468.

[266] Email from John Tokarczyk (Bear, Stearns & Co. Associate Director) to Jeffrey Maggard (Bear, Stearns & Co. Managing Director and Deal Manager on the BSSLT 2007-1 Transaction), dated April 30, 2007, EMC-AMB 001469603-604.

the trading desk would become irate. For example, by March 2007, when Bear Stearns confirmed that it missed the opportunity to securitize $73 million worth of loans in its inventory before they experienced an EPD – 74% of which did not comply with Bear Stearns' then-current guidelines[267] –Verschleiser demanded to know "why any of these positions were not securitized," and did "not understand why they were dropped from deals and not securitized before their epd period."[268] Similarly, in May 2007, the same Managing Director in trading that had first conveyed the EPD policy-change in early 2006 demanded "to know why we are taking losses on 2nd lien loans from 2005 when they could have been securitized?????"[269]

D. EVEN AS IT REVIEWED BREACHING LOANS IN 2007, BEAR STEARNS CONTINUED TO CONCEAL ITS FRAUD AND FAILED TO GIVE "PROMPT NOTICE" OF THE SECURITIZATION BREACHES

184. Bear Stearns' practices resulted in the blatant disregard of EMC's contractual commitments to give "prompt written notice" to Ambac and other deal participants of breaching loans found in the securitizations, and cure, substitute or repurchase defective and breaching loans from the securitization trusts within 90 days.[270]

185. As advised by its outside auditors in mid-2006, and thereafter by its counsel, after identifying problems in the loans, Bear Stearns was and is obligated to promptly assess whether there is a breach affecting the loans in its securitizations. Contrary to that advice, Bear Stearns failed to establish the requisite policies and practices to review loans for securitization breaches until late 2007. Indeed, Bear Stearns did not even establish a formal "securitization breach

[267] Email from John Mongelluzzo (Bear Stearns & Co. Vice President, Due Diligence) to Jeffrey Verschleiser, Baron Silverstein and Mary Haggerty, among others, dated March 21, 2007, EMC-AMB 006798661.

[268] Email from Jeffrey Verschleiser to Baron Silverstein and Mary Haggerty, among others, dated March 1, 2007, EMC-AMB 006087607-609.

[269] Email from Keith Lind (Bear, Stearns & Co. Managing Director, Trading), dated May 5, 2007, EMC-AMB 002283474 – 475.

[270] *See* Section V.C, below.

team" until Spring 2007.[271] The securitization breach team began its tenure by immediately highlighting Bear Stearns' failings with respect to its contractual obligations to timely review loans for securitization breaches.

186. In May 2007, the Bear Stearns manager responsible for its newly created securitization breach team reiterated the very failings that PWC had identified in 2006, including that (i) Bear Stearns' "Claims [department] is only addressing repurchase/settlement from the original Seller and the time frames provided to the Seller and Claims exhausts the time frames allowed for Securitization review/buyout," (ii) "Securitization review/buyout must be completed within 90 days of the Breach being identified," but is not being done within that time frame, and (iii) "Missing compliance with the Securitization time frames creates Reg. AB issues and violations."[272] The manager's findings are consistent with the August 15, 2007 version of Bear Stearns' policy governing the review and repurchase of loans from securitizations, which states that "***No loan(s) will be added to the Conduit Buy out Log . . . without confirmation of repurchase funds received or a firm commitment from the seller to repurchase or the funding of a down-bid***."[273] (The Conduit Buy-out Log is the file Bear Stearns used to track loans that were to be repurchased from a securitization under its repurchase commitments.) As late as mid-August 2007, therefore, Bear Stearns was directing its employees that the repurchase of loans

[271] 4/26/2010 Golden Deposition Tr. at 60-61; Email from Fernando Serrano, dated April 24, 2007, EMC-AMB 010726553-556 at 554 (noting that quality control department "[i]mplemented and established the Securitization Breach Department" in the first quarter of 2007).

[272] Email from Amy Adame (EMC Mortgage Corp., Quality Control Supervisor, Securitization Breach Team) to Fernando Serrano (EMC Mortgage Corp., Quality Control Manager), dated May 31, 2007, EMC-AMB 010814501-502.

[273] EMC-AMB 002571130-132 at 131 (emphasis added). A separate internal Bear Stearns policy manual from August 10, 2007 sets out a similar procedure and explains that the Repurchase Log manual explains that, like the "Conduit Buy Out Log," the Repurchase Log is maintained to facilitate the buy-out of loans in securities, but that this process beings only "[w]hen a Seller commits to repurchasing a loan[.]" EMC-AMB1 000001343-1346.

from a securitization was not even to be considered unless and until there was a recovery *by* EMC relating to the loans from the entity from which it purchased the loans.

187. It was not until September 2007 that Bear Stearns revised its "process flow for determining security breach of loans." As the securitization breach manager explained, "[r]ather than the current process which occurs when the claim results in a repurchase by the Seller or a settlement by the Seller, it will now happen in the front end. . . This will happened [sic] potentially even before you file a claim with the Seller."[274] Four days later, Bear Stearns for the first time "implemented the policy of ***fully honoring our obligations*** to pro-actively review defective loans for potential PSA breach."[275] The new policy stated that "going forward all defective loans are reviewed for a securitization breach concurrent with the QC review."[276]

188. At about the same time it formed the securitization breach team in early 2007, Bear Stearns also for the first time directed its outside vendor Adfitech to start conducting limited "securitization breach reviews" on an "as requested" basis.[277] Reflecting its bad faith and duplicitous approach to its contractual obligations, however, it instructed Adfitech to conduct a very limited review of loans submitted by Bear Stearns for review. In particular, Bear Stearns directed Adfitech *not* to undertake any reasonable underwriting efforts to verify the information in the loan file, stating (i) "Effective immediately, in addition to not ordering occupancy

[274] Email from Fernando Serrano (EMC Mortgage Corp., Quality Control Manager) dated September 10, 2007, EMC-AMB 010725797-799 (discussing the "9/5/07 QC Minutes/Overview").

[275] Email from Leslie Rodriguez (EMC Residential Mortgage Managing Director), dated September 14, 2007, EMC-AMB 006870106-110 at 108, 107 (emphasis added) (acknowledging that "further discussion as to how Reps and Warrants, Conduit QC and Security Breach QC interact in this manner may definitely be warranted.")..

[276] EMC-AMB 011688248-249, "Securitization Breach Quality Control Review."

[277] Email from Sherrie Dobbins (EMC Mortgage Corporation Assistant Manager, Quality Control Underwriting and Vendor Management) to Greg Anderson (Adfitech quality control manager), dated April 5, 2007, ADFITECH_3112_00005402; *see also* Email from Sherrie Dobbins (EMC Mortgage Corporation Assistant Manager, Quality Control Underwriting and Vendor Management) to Greg Anderson (Adfitech quality control manager), dated July 6, 2007, EMC-AMB 006955548.

inspections and review appraisals, DO NOT PERFORM REVERIFICATIONS OR RETRIEVE CREDIT REPORTS ON THE SECURITIZATION BREACH AUDITS," (ii) not "make phone calls on employment," and (iii) gave the blanket instruction that "occupancy misrep is not a securitization breach."[278] The head of the securitization breach team testified that he did not share that restrictive view of an appropriate securitization breach review.[279] Notwithstanding Bear Stearns' improper and divergent limitations, Adfitech still found securitization breaches in ***42.9%*** of the loans it reviewed from the Transactions.

189. Because Bear Stearns only had conducted a limited securitization breach review starting in 2007 – and had not been conducting securitization breach reviews when loans were deemed defective by its quality control department or subject to a settlement with a supplier of the loans – there was a growing backlog of securitized loans that had never been reviewed for a potential breach of EMC's representations and warranties. By September 2007, Bear Stearns acknowledged having to conduct a securitization breach review of at least 1,800 loans included in a settlement prior to August 2, 2007, as well as a backlog of over "4,000 defective loans that came out of the QC dept in the last year."[280] Bear Stearns did not disclose to Ambac or investors in 2007 the changes in its securitization breach policies, the securitization breaches it identified, or the backlog in its securitization breach reviews.

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[278] *Id.*

[279] 6/10/2010 Peacock Deposition Tr. at 182-93 (stating that the securitization breach team was directed to "whatever sources that were available," including but not limited to (i) "findings made by quality control," (ii) "reverifications or other information . . . that was provided by the QC group," (iii) "third-party resources," (iv) "phone calls to borrowers," (v) "tax records of the borrower," and (vi) "phone calls to the borrower's employer" to verify employment). The same manager of the securitization breach team did not identify any instance where the team was "trying to limit our sources." *Id.* at 187-88.

[280] E-mail from Whitney Long (EMC Residential Mortgage, Vice President of Risk Management and Claims) to, among others, Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President) and Leslie Rodriguez (EMC Residential Mortgage Managing Director), dated September 13, 2007, EMC-AMB 007176791-800 at 792.

190. But after September 2007, Bear Stearns' obligation to repurchase securitized defective loans still went unaddressed while the trusts suffered losses. Indeed, even as late as May 28, 2008, an internal audit of the representations and warranties department revealed that "loans identified as 'defective' (loans not conforming to contractual agreement) ***were still not always being referred for a securitization breach review.***"[281] As of May 2008, Bear Stearns still faced a backlog of nearly 4,000 defective securitized loans *dating back to 2000* that had never been reviewed for a potential breach of EMC's representations and warranties.[282] In the meantime, the "vast majority" of these defective loans fell into delinquency and defaulted to the detriment of the securitizations.[283] In 2008, as mortgage originators fell into insolvency and went out of business, many of the defective loans on the backlog for securitization breach review remained subject to outstanding repurchase claims by Bear Stearns against those loan sellers. As an EMC witness described them, these were "sellers who are in distress"[284] that were "close to going out of business."[285] Rather than review, albeit belatedly, all defective loans on the securitization breach review backlog – as its outside auditors and counsel had advised and its new policies purportedly dictated – Bear Stearns improperly ***removed*** from the backlog, without ever performing the requisite review, loans subject to repurchase claims against out-of-business

[281] "Bear Stearns Internal Audit Report – EMC Mortgage Corporation ('EMC') Limited Review of Representations and Warrants Department," EMC-AMB 010858511-515.

[282] E-mail from Alan Lu (J.P. Morgan Securities Inc. Claims Analyst) to Ashley Poole (EMC Mortgage Corporation Analyst, Representations and Warranties Department), dated May 13, 2008, and attached report of "Security Breach Review Back Log Delinquency Information," EMC-AMB 009103232-233 (emphasis added).

[283] *See* 9/25/10 Lu Deposition Tr. at 190 (confirming that the "vast majority" of loans on the securitization breach review backlog were "delinquent 360 plus days"). E-mail from Alan Lu (J.P. Morgan Securities Inc. Claims Analyst) to Ashley Poole (EMC Mortgage Corporation Analyst, Representations and Warranties Department), dated May 13, 2008, and attached report of "Security Breach Review Back Log Delinquency Information," EMC-AMB 009103232-233.

[284] 9/25/10 Lu Deposition Tr. at 204.

[285] *Id.* at 205.

sellers and other "sellers in distress."[286] The same May 28, 2008 internal audit report also concluded that even in rare cases when Bear Stearns did perform securitization breach reviews and determined that the defective loans "should be repurchased from the deal," "not all the loans had been repurchased."[287] These defective loans, which Bear Stearns itself found to breach securitization representations and warranties but failed to repurchase, include Mortgage Loans in the Transactions that have been charged off as losses to the Trusts.[288]

191. Without the benefit of disclosures regarding the true nature of Bear Stearns' practices, it was not until late 2007 that Ambac started noticing that the performance of the Transactions was deteriorating. After realizing the Transactions were performing far worse than expected, Ambac began investigating whether the loans in the Transactions complied with EMC's representations and warranties. Ambac requested loan files for 695 defaulted loans and hired an independent consultant to review the loans files. After receiving Ambac's requests, on or about October 2007 Bear Stearns hired Clayton as a third party consultant to perform a due diligence review of the loan files that Ambac requested. Unbeknownst to Ambac and under Silverstein's direction, the vice president in charge of Bear Stearns' due diligence led an effort to collect the loan files so that they could be sent to Clayton for this due diligence review.[289] The

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[286] *See* 9/25/10 Lu Deposition Tr. at 205-13, questioning regarding email from Alan Lu (J.P. Morgan Securities Inc. Claims Analyst) to Tamara Jewell (J.P. Morgan Securities Inc. Project Manager), dated April 7, 2008, and attached "Securitization Breach Review Defective Rate Detail" report, EMC-AMB 009089704-705 (confirming that loans with "canceled/cured repurchase claims" against sellers "in distress" were "subtracted from the securitization breach review pipeline").

[287] "Bear Stearns Internal Audit Report – EMC Mortgage Corporation ('EMC') Limited Review of Representations and Warrants Department," EMC-AMB 010858511-515.

[288] *See, e.g.*, Email from Whitney Long (EMC Residential Mortgage, Vice President of Risk Management and Claims) to Alison Malkin (J.P. Morgan Securities Inc. Executive Director, Securitized Products), dated April 22, 2008, EMC-AMB 007169162-163 ('Attached is the pipeline of loans pending security buyout.").

[289] Email from John Mongelluzzo (Bear Stearns & Co. Vice President, Due Diligence) to Baron Silverstein (Bear, Stearns & Co. Senior Managing Directors, Co-Head Mortgage Finanace), dated

same vice president and a due diligence manager then coordinated and directed Clayton's review of the loan files.[290] During the time of the review, Silverstein reported to Nierenberg and Verschleiser that the review was taking place along with other due diligence audits.[291]

192. Clayton's review found that the sample of loans contained pervasive material breaches. Clayton performed a due diligence review of the loans and sent EMC daily reports showing Clayton's breach findings.[292] The final report produced for this review identified material breaches for ***56%*** of the loans.[293] Bear Stearns never told Ambac that it hired Clayton to review these loans and did not inform Ambac of Clayton's findings. Nor did Bear Stearns provide Ambac or any other participant with "prompt notice" of the breaches Clayton identified in 2007.

193. Making matters even worse, after deliberately concealing the defects identified by Clayton at the end of 2007, in mid-2008 Bear Stearns also ignored its commitments to repurchase or cure these non-compliant loans. Specifically, Ambac's analysis, like Clayton's, also revealed breaches of representations and warranties in almost 80% of the loans examined, with an aggregate principal balance of approximately $40.8 million. Upon completing its analysis, by letters dated April 25 and May 23, 2008, Ambac asked EMC, in compliance with its

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October 31, 2007, EMC-AMB 001424875-878 ("We have investors who are asking for files to review that are at the servicer. I'm going to need to arrange diligence.").

[290] Email from John Mongelluzzo (Bear Stearns & Co. Vice President, Due Diligence) to Pattie Sears (EMC Mortgage Corporation, Due Diligence Manager) and Adam Peat (Clayton Client Service Manager), dated October 31, 2007, EMC-AMB 001728476-483.

[291] E-mail from Baron Silverstein to, among others, Jeffrey Verschleiser and Michael Nierenberg, dated November 12, 2007, EMC-AMB 001422820-821.

[292] E-mail from Pattie Sears (EMC Mortgage Corporation, Due Diligence Manager) to, among others, John Mongelluzzo (Bear Stearns & Co. Vice President, Due Diligence), dated November 5, 2007, EMC-AMB 011012036-037.

[293] CLAY-AMBAC 019669, November 16, 2007 Loan Disposition Summary (AMB0710) prepared by Clayton Services, Inc. for Bear Stearns. Clayton reviewed 596 Ambac loans and found "material" issues with 337.

contractual obligations, to cure, repurchase, or provide substitutes for approximately 526 breaching loans, but EMC refused to do this for all but a few. As discussed further in Section III.F below, as of May 2008, JP Morgan had assumed control of EMC and immediately instituted a policy barring EMC from honoring legitimate repurchase requests from Ambac as well as other insurers and investors. Thereafter, by letters dated July 21 and August 20, 2008, the executive director of JP Morgan's Securitized Products division (Alison Malkin) with no prior knowledge of the Transactions rejected Ambac's breach notices regarding these non-compliant loans, even though Bear Stearns itself hired a third party consultant to conduct a review of the loans and identified material breaches throughout the very same sample of loans.

194. Bear Stearns also did not disclose that, in the same time frame, it implemented a trading strategy to capitalize on the harm resulting from its fraudulent and breaching conduct. That is, Bear Stearns implemented a trading strategy to "short" banks with large exposure to Ambac-insured securities. In his November 2007 self-evaluation, Verschleiser bragged that at "the end of October, while presenting to the risk committee on our business I told them that a ***few financial guarantors were vulnerable*** to potential write downs in the CDO and MBS market and ***we should be short*** a multiple of 10 of the shorts I had put on . . . In less than three weeks we made approximately $55 million on just these two trades."[294]

195. Bolstered by this success, Bear Stearns carried this trading strategy into 2008. On February 17, 2008, a Bear Stearns trader told colleagues and Verschleiser, "***I am positive fgic is done and ambac is not far behind***."[295] The next day, in the same email chain, the trader again wrote to Verschleiser and others to clarify which banks had large exposures to Ambac, asking

[294] Email from Jeffrey Verschleiser (Bear, Stearns & Co. Senior Managing Director, Head of ABS & Wholeloan Desk), dated November 20, 2007, EMC-AMB 009600760-763.

[295] Email from Adam Siegel (Bear Stearns & Co. Senior Managing Director, ABS/MBS Credit Trading), dated February 17, 2008, EMC-AMB 012117052-063.

"***who else has big fgic or abk [Ambac] exposures besides soc gen?***"[296] A colleague replied: "I believe the five with the biggest exposures are Barclays, CIBC, Merrill, Soc Gen and UBS. I think ABN, BNP, DB, HSBC and RBS have less."[297] Bear Stearns in fact entered into short positions with respect to those banks.[298]

196. As it was "shorting" the banks holding Ambac-insured securities, Bear Stearns continued to conceal the defects it discovered relating to collateral that back the securities issued in the Transactions.

E. BEAR STEARNS THREATENED THE RATING AGENCIES TO AVOID DOWNGRADES THAT REFLECTED THE TRUE VALUE OF ITS SECURITIES

197. The Offering Documents used to market the securities issued in each of the Transactions affirmatively state that the rating agencies "will monitor the ratings it issues on an ongoing basis and may update the rating after conducting its regular review . . . ."[299]

198. By mid-October 2007, the rating agencies had become increasingly concerned with the accuracy of the disclosures made by Bear Stearns regarding its mortgage-backed securities. As a consequence, S&P and Moody's downgraded the ratings on Bear Stearns' mortgaged-backed securities. Tom Marano was indignant at the gall of the rating agencies to contravene the will of Bear Stearns. In no uncertain terms, he directed his staff to cut-off all fees due to the rating agencies:

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[296] Email from Adam Siegel (Bear Stearns & Co. Senior Managing Director, ABS/MBS Credit Trading) to Jeffrey Verschleiser, among others, dated February 18, 2008, EMC-AMB 012117048-051.

[297] Email from Warren Saft (Bear Stearns & Co. trader), to Verschleiser, among others, dated February 18, 2008, EMC-AMB 012117048-051.

[298] Email from Beau Paulk (Bear Stearns & Co. employee) to Marano, Nierenberg, and Verschleiser, among others, dated March 17, 2008, EMC 011189682-83 (attaching "Department Hedge Summary" as of March 14, 2008). Bear Stearns also entered into credit default swaps wherein it stood to profit on Ambac's demise. *Id.*

[299] SACO 2006-8 ProSupp at S-89; BSSLT 2007-1 (Group I) ProSupp at S-109.

> "My intention is to contact my peer at each firm as well as the investors who bought the deals. From there, we are going to demand a waiver of fees. In the interim, ***do not pay a single fee to either rating agency. Hold every fee up***."[300]

199. Even the Bear Stearns Managing Director hired from a rating agency to liaise with the agencies conceded that Bear Stearns' attempt to browbeat the rating agencies was improper.[301] But Bear Stearns' attempt to coerce the rating agencies to manipulate their ratings was just one of the many improper measures it took to avoid recognition of its liability arising from its securitizations.

F. AFTER THE MERGER WITH JP MORGAN, BEAR STEARNS IMPLEMENTED POLICIES TO REJECT WHOLESALE ITS REPURCHASE OBLIGATIONS TO MANIPULATE ITS ACCOUNTING RESERVES

200. After JPMorgan Chase & Co. acquired Bear Stearns for nominal consideration following its remarkable collapse in the spring of 2008, JP Morgan deliberately frustrated investors' and insurers' rights in the Bear Stearns securitizations in order to avoid bringing Bear Stearns' massive exposure related to its securitizations into its consolidated financial statements. Most significantly, JP Morgan implemented a bad-faith strategy to reject without justification insurers' and investors' demands for the repurchase of breaching loans from the Bear Stearns securitizations.

201. Shortly after taking control of Bear Stearns' operations in March 2008, JP Morgan implemented a moratorium on the repurchase of breaching loans from securities. On May 16, 2008, the Executive Director of JP Morgan's Securitized Products division (Alison Malkin) issued an email alerting Bear Stearns employees "***IMPORTANT: Please do not***

[300] Email from Marano to Silverstein, Cheryl Glory (Bear, Stearns & Co. Managing Director, Mortgage Finance), et al., dated October 17, 2007 , EMC-AMB 001424910-912 (emphasis added)

[301] 4/19/2006 Glory Deposition Tr. at 73. *See also id.* at 82-83 (After being confronted with Marano's email, Ms. Glory conceded that it is "not normal course of business.").

repurchase any loans" because "JPM is evaluating processes and has put a temporary hold until they have finished."[302] On July 14, 2008, Malkin reinforced the absolute nature of JP Morgan's directive, stating that ***"[t]he only way a loan can be repurchased from a deal is if I send an email***."[303] With the moratorium in place, JP Morgan immediately began (i) cancelling the repurchase of large volumes of loans that Bear Stearns previously determined had to be repurchased, and (ii) arbitrarily denying subsequent demands by investors and insurers to repurchase breaching loans from Bear Stearns' securitizations.

202. In May 2008, with "less than a month on the job," Malkin told the Bear Stearns executives previously responsible for the breach review that their "own breach determinations with respect to its own loans in its own securitizations are incorrect," and "reversed EMC/Bear's findings of breaches with respect to the very loans that are at issue in this transaction."[304] In her initial review alone, conducted on or about May 5, Malkin "disagreed with ***56%*** of EMC/Bear Stearns findings."[305] The rationale and motivation of Malkin's reversals was not lost on the former Bear Stearns executives, who observed that "[f]rom ***a reserves standpoint*** . . . the number has dropped from $31M/-$13.9M to $17M/-$7.6M."[306] Thus, within days of assuming control of

[302] Email from Alison Malkin (J.P. Morgan Securities Inc. Executive Director, Securitized Products) to Ashley Poole (EMC Mortgage Corp. Analyst, Representations and Warranties Department) and Whitney Long (EMC Residential Mortgage Vice President, Risk Management and Claims), dated May 16, 2008, EMC-AMB 007165488-490 at 489 (emphasis added).

[303] Email from Alison Malkin (J.P. Morgan Securities Inc. Executive Director, Securitized Products) to Gary Lyles (Bear Stearns & Co., Internal Audit Department), dated July 14, 2008, EMC-AMB 010858522-524.

[304] 1/22/2010 Megha Rule 30(b)(6) Deposition Tr. at 190-92.

[305] Email from Whitney Long (EMC Residential Mortgage, Vice President of Risk Management and Claims) to Alison Malkin (J.P. Morgan Securities Inc. Executive Director, Securitized Products), dated May 5, 2008, EMC-AMB 007173918-919.

[306] *Id.* (emphasis added).

the repurchase process, JP Morgan cut by over half the breach findings made in order to reduce by a corresponding amount JPMorgan Chase & Co.'s accounting liability.

203. In an effort to justify its reversal of the repurchase determinations, JP Morgan caused EMC to take newfound positions as to circumstances in which loans must be repurchased from a securitization that were inconsistent with, and contravened, EMC's own interpretation of its obligations prior to May 2008.

204. Bear Stearns' securitization breach team knew full well that JP Morgan's newly imposed bases for rejecting repurchase demands were contrived. For instance, Malkin took the position that the following were not breaches warranting the repurchase of loans from the securitization: (i) the absence of key documentation from the loan file (without which the loan could be rescinded) and (ii) a finding that the borrowers' stated income was unreasonable for the loan given. The head of Bear Stearns' securitization breach team was properly baffled by those positions: "The idea that missing certain significant docs is not a security breach issue is a fairly foreign concept that I have just not gotten my mind around yet. The stated income issue is very similar, in that the reasonableness test was a requirement in virtually all the guidelines from the various lenders that we obtained loans from."[307] Nonetheless, there was nothing the former Bear Stearns executive could do, as post-merger "ultimately the authority to resolve any debate sat with JPMorgan."[308] Thus, at JP Morgan's directive, on May 14, 2008, the executive canceled the repurchase of loans that "we have previously added to the Repurchase Log, but we need to re-address using our ***updated*** standards."[309]

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[307] Email from Michael Peacock (EMC Mortgage Corporation Securitization Breach Team) to Tamara Jewell (EMC Residential Mortgage, Project Manager), dated May 8, 2008, EMC-AMB 007173931-932.

[308] 6/10/2010 Peacock Deposition Tr. at 254-56.

[309] Email from Michael Peacock (EMC Mortgage Corporation Securitization Breach Team), dated May 14, 2008, EMC-AMB 009119930-931 at 931 (emphasis added).

205. Once the pending repurchase determinations had been "adjusted," JP Morgan implemented an across-the-board policy of rejecting Ambac's and other insurers' and investors' repurchase demands to manipulate its accounting reserves and conceal from JPMorgan Chase & Co.'s consolidated financials the massive liability owed for Bear Stearns' fraudulent securitization practices. Reflecting this bad-faith initiative, as it was confronted with an escalating volume of repurchase demands, JP Morgan steadily increased its overall denial rate: JP Morgan denied 83% of all claims reviewed between May and June 2008,[310] and thereafter denied claims on virtually all the breaching loans identified in Ambac's subsequent repurchase demands.

206. During this same time period, Ambac began making increasing numbers of repurchase demands arising from EMC's breaches of its representations and warranties pertaining to the loans in the Transactions. Among the loans initially submitted for repurchase were the 526 loans that Bear Stearns had re-underwritten with Clayton in the late 2007. Although Ambac provided detailed substantiation for the breaches identified, in July and August 2008, Malkin responded on EMC's behalf under the contractual agreements with Ambac and rejected Ambac's repurchase requests for virtually all of the breaching loans. The duplicity and improper basis for JP Morgan's contrived rejections is evident when compared to the 56% breach rate Bear Stearns and Clayton found before the JP Morgan merger for the 526 loans that comprised the majority of loans EMC refused to repurchase in Malkin's July and August 2008 responses.

207. The fraud and improper conduct reflected in JP Morgan's duplicitous conduct also is patent from the repurchase demands JP Morgan made on behalf of EMC against the

[310] *See* Claims Against EMC Exposure Rollforward as of June 18, 2008, EMC-AMB 008922742.

suppliers of the loans in the Bear Stearns securitizations pertaining to the very same loans that were submitted for repurchase from EMC. That is, while simultaneously rejecting Ambac's and other insurers' positions and refusing to repurchase breaching loans, JP Morgan advanced those very same breach positions in an attempt to recover funds for itself from originators that supplied the loans to EMC. The following examples for loans in the SACO 2005-10 Transaction gleaned from Bear Stearns' own files obtained in discovery illustrate this abhorrent conduct:

- ***EMC Loan Number [redacted]:*** After Bear Stearns securitized the loan, Ambac discovered material breaches in the loan and issued a repurchase request to EMC on October 20, 2008 because *inter alia* the loan was missing verification that the borrower had two years employment as required by the guidelines. By letter dated January 5, 2009, JP Morgan then demanded that the loan originator repurchase the same loan asserting the position that it is "believed by the Purchaser [EMC] to be breach [sic] Mortgage Loan" because "[t]he file does not contain documentation to support the borrower has been self employed for two years as required by guidelines," and thus adopting verbatim the exact same breach described in Ambac's repurchase request. Yet just days later, on January 16, 2009, EMC rejected Ambac's repurchase claim claiming that "the subject borrower, loan and/or property satisfied applicable guidelines or reasonable exceptions thereto at the time that the loan was made."

- ***EMC Loan Number [redacted]:*** After Bear Stearns securitized the loan, Ambac discovered material breaches in the loan and issued a repurchase request to EMC on October 20, 2008 because "the underwriter has shown negligence in qualifying the borrower for a loan she could not reasonably afford. . . The borrower would need to state $6050/month to meet the 45% maximum DTI." By letter dated January 5, 2009, JP Morgan then demanded that the loan originator repurchase the same loan asserting the position that it is "believed by the Purchaser [EMC] to be breach [sic] Mortgage Loan" and copied nearly verbatim the exact same underwriting failures and defects described in Ambac's repurchase request. Yet just days later, on January 16, 2009, EMC rejected Ambac's repurchase claim.

- ***EMC Loan Number [redacted]:*** After Bear Stearns securitized the loan, Ambac discovered material breaches in the loan and issued a repurchase request to EMC on October 20, 2008 because *inter alia* the underwriter was negligent in qualifying the borrower for a loan she could not reasonably afford, the loan was missing verification of employment, and the credit report was not in the file. By letter dated January 5, 2009, JP Morgan then demanded that the loan originator repurchase the same loan asserting the position that it is "believed by the Purchaser [EMC] to be breach [sic] Mortgage Loan" because the borrower's income did not pass a "reasonability test" and the file was missing a verification

of employment and original credit report. Once again, despite acknowledging the breaches identified by Ambac, just days later, on January 16, 2009, EMC rejected Ambac's repurchase demand, claiming that "[t]he subject borrower, loan and/or property satisfied applicable guidelines or reasonable exceptions thereto at the time that the loan was made."

- ***EMC Loan Number [redacted]:*** After Bear Stearns securitized the loan, Ambac discovered material breaches in the loan and issued a repurchase request to EMC on April 25, 2008 because *inter alia* the borrower's stated income of $12,500 was overstated and the employment was misrepresented. EMC rejected Ambac's repurchase claim on July 21, 2008 claiming that "EMC is not in receipt of documentation to dispute borrower's income as represented." In direct contravention of EMC's response to Ambac, by letter dated September 19, 2008, JP Morgan demanded that the loan originator repurchase the same loan asserting the position that it is "believed by the Purchaser [EMC] to be breach [sic] Mortgage Loan" because the "borrower's employment as stated on the application was misrepresented" and "the income of $12,500 provided in the application is unreasonable."

208. In addition to the foregoing examples, documents and databases uncovered from JP Morgan's internal files show that at the same time that JP Morgan "disagreed" with approximately 6,000 breaching loans identified in Ambac's repurchase requests, JP Morgan was issuing repurchase requests to originators for at least 736 of those loans between June and August 2009 reciting the same or similar breaches in those loans that JP Morgan rejected in its responses to Ambac.

209. JP Morgan also rebuffed Ambac's breach claims and barred repurchase of loans even where Bear Stearns had previously demanded that the originator repurchase the exact same loan. Bear Stearns' formal claims notices and supporting quality control documentation issued to loan originators reveal loans suffering from borrower misrepresentations, fraud, underwriting failures, missing documentation and other defects that by Bear Stearns' own admission, "were not eligible for delivery," and thus should never have been securitized.[311] JP Morgan

[311] Consistent with the representations and warranties and remedies that EMC extended to Ambac in the MLPAs, Bear Stearns purchased loans pursuant to a mortgage loan purchase agreements that require the seller to repurchase or cure any loan defects that "materially and adversely" affect the value of a loan, or

intentionally and knowingly concealed these repurchase claims and asserted factual positions that were directly contrary to Bear Stearns' own affirmative investigations confirming the very same defects that Ambac subsequently identified in the same loans, which include by way of example the following:

- ***EMC Loan Numbers*** [redacted], [redacted], [redacted], [redacted], [redacted], ***and*** [redacted]***:*** After Bear Stearns securitized the loans in one of the Transactions, it submitted a repurchase claim against the entities from which it purchased the loans on the grounds that the borrower failed to disclose existing liabilities at time of origination. Bear Stearns asserted that the loans violated underwriting guidelines and/or were originated through fraud, error, negligence, misrepresentation or material omission. In response to Ambac's subsequent repurchase demands based on the same defect, EMC refused to repurchase the loans stating: "There is no documentation in the file reflecting debts existed at the time of origination but were not considered by the lender. The loan file contains a credit report conforming to the applicable guidelines and all reported obligations were used in the underwriting process."

- ***EMC Loan Number*** [redacted]***:*** After Bear Stearns securitized the loan in the SACO 2005-10 Transaction, it submitted a repurchase claim against the entity from which it purchased the loan on the grounds that the verification of rent in the credit file was misrepresented because its quality control review confirmed that "the borrower ***never paid $1,275 in monthly rent***," rather "the monthly rent was $750." Accounting for actual rental payment, Bear Stearns asserted that the loan violated underwriting guidelines. In response to Ambac's subsequent repurchase demand based on the same defect, EMC refused to repurchase the loan stating the loan complied with underwriting guidelines and asserting the position that "the ***[verification of rent] in file that shows the borrower has been paying rent of $1275 for 58 months***."

- ***EMC Loan Number*** [redacted]***:*** After Bear Stearns securitized the loan in the SACO 2006-2 Transaction, it submitted a repurchase claim against the entity from which it purchased the loans on the grounds that misrepresentation of income violated underwriting guidelines requiring that "income be reasonable for the position." Bear Stearns supported its claim with the borrower's bankruptcy petition filed after the origination date of the loan. In response to Ambac's subsequent repurchase demand based on the same defect and which also referenced the borrowers' bankruptcy petition, EMC refused to repurchase the

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EMC's interests therein. *See* EMC Seller Guide (effective Oct. 3, 2005) § 11.03, EMC-AMB 003378797-883 at p. 66; *see also* Mortgage Loan Purchase and Interim Service Agreement between EMC and SunTrust Mortgage (dated May 1, 2002) § 7.03,STM-00007246-7250. *See also* Section III.C.3, above.

loan stating that the loan complied with underwriting guidelines and asserting the position that "Borrower misrepresentation (if any) discovered subsequent to closing is not a breach of the representations and warranties stated."

210. Moreover, as discussed above, to quietly resolve its repurchase claims, Bear Stearns also entered into confidential settlement agreements providing it with a monetary payment, that it pocketed in lieu of repurchasing the toxic loans from the securitizations. To date, EMC has produced over 100 of these confidential settlement agreements, many of which show that EMC recovered significant funds concerning the very same loans Bear Stearns securitized in one of the Transactions. These settlement agreements not only confirm the validity of Ambac's repurchase demands, but demonstrate JP Morgan's duplicity in causing EMC to reject those demands for illegitimate ends and keep those recoveries for itself. The following settlements are illustrative:

- EMC's Settlement Agreement with SouthStar Funding LLC, dated January 30, 2007, EMC-AMB 008911066-82: In this agreement, SouthStar "agree[d] to pay $2,604,515.26 *in lieu of repurchasing* the Defective Loans . . . ." The settlement resolved EMC's claim as to at least 12 of the loans in the Transactions, including EMC Loan Number [redacted]. For this loan, EMC identified a "Problem Request Type" for "OCCU REP." Bear Stearns' internal databases further states that for this loan: "THE BORROWER DID NOT OCCUPY THE SUBJECT PROPERTY AS SOLD TO EMC." Even though Bear Stearns securitized this loan on the basis that it was owner occupied, after this settlement agreement was finalized, EMC continued to conceal the defect and rejected Ambac's put-back request – ***also based on an occupancy misrepresentation*** – claiming that "[t]here is no documentation in the loan file negating the borrower's intent at the time of funding to occupy the subject property."

- EMC's Settlement Agreement with Plaza Home Mortgage, dated October 1, 2007, EMC-AMB 004729716-33: In this agreement, Plaza Home Mortgage "agree[d] to pay $1,000,000.00 to EMC . . . *in lieu of repurchasing* the Defective Loans . . . ." At least 20 of the 33 loans included in the settlement are loans in one of the four Transactions at issue.

- EMC's Settlement Agreement with SunTrust Mortgage, dated December 18, 2007, EMC-AMB 008911045-65: In this agreement, "[w]ith regard to the Defective Loans . . . the Company and EMC agree as follows . . . the Company shall pay to EMC an amount equal to $11,874,031.09 . . . for full payment and satisfaction of the Monetary Claims, and the balance of the Settlement Amount (if

any) for settlement of the Defective Loans." Of the 67 loans included for non-EPD reasons, at least 7 loans are Transaction loans.

211. JP Morgan's scam was not limited to Ambac, but was part and parcel of a bad-faith corporate policy. Indeed, JP Morgan has engaged in identical fraudulent conduct involving other financial guaranty insurers including Syncora Guarantee Inc. ("Syncora"), a monoline similarly situated to Ambac, in a deal involving mortgage loans of similar type and vintage as the Transactions. For example, on March 4, 2008, Syncora, which also insured Bear Stearns securitizations, gave formal notice to EMC of 380 securitized loans that breach one or more of EMC's representations and warranties, and described the breaches affecting each loan with specificity.[312] Within days after receiving Syncora's notice, on March 11, Bear, Stearns & Co.'s Managing Director of claims issued a repurchase demand on EMC's behalf to GreenPoint, the entity that sold those loans to EMC prior to securitization, asserting that the ***same exact breaches*** identified by Syncora constitute breaches of GreenPoint's representations and warranties under its agreement with EMC.[313] (In its notice, EMC even attached Syncora's detailed description of such breaches.) GreenPoint refused to repurchase the loans because, among other things, EMC had not repurchased any of those loans from the securitization and, thus, suffered no loss.[314] Thereafter, on June 26, 2008, JP Morgan's Executive Director Alison Malkin continued to pursue EMC's claims against GreenPoint, adamantly asserting "***that it is EMC's position that***

[312] Letter from XL Capital Assurance, Inc. to EMC Mortgage Corp., dated March 4, 2008, EMC-SYN 000002855-58

[313] Letter from Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President) to GreenPoint Mortgage Funding, Inc., dated March 11, 2008, EMC-SYN 00283796 - 99

[314] Letter from Rose Medina (GreenPoint Vice President, Rep & Warranty) to Stephen Golden (Bear, Stearns & Co. Managing Director, Warehouse and EMC Residential Mortgage President), undated, EMC-SYN 00283794-95 (responding to Stephen Golden's March 11, 2008 letter)

these breaches materially and adversely affect the value of the [loans]."[315] Remarkably, at the same time as JP Morgan was attempting to recover from GreenPoint by adopting Syncora's breach positions as its own, Malkin took diametrically opposing positions in repeatedly refusing to comply with all but 4% of Syncora's repurchase demands.[316] In the end, Syncora was left with no alternative but to file suit against EMC to recover for its breaches.[317]

212. Yet another form of JP Morgan's interference with EMC's repurchase obligations was preventing EMC from repurchasing breaching loans put back by investors and insurers where JP Morgan could not recoup its losses from the sellers of those breaching loans. A witness who performed claims analysis for EMC until the JP Morgan takeover and maintained the same role for JP Morgan under the direction of Alison Malkin[318] confirmed that JP Morgan

[315] Letter from Alison Malkin (J.P. Morgan Securities Inc. Executive Director, Securitized Products) to Rose Medina (GreenPoint Vice President, Rep & Warranty), dated June 26, 2008, EMC-SYN 000003048; 1/22/2010 Megha 30(b)(6) Deposition Tr. 257-58 (Q: So there's no ambiguity whatsoever that as of June 26, 2008, EMC was taking the position that the breaches that Syncora identified materially and adversely affected the value of the revolving credit lines, correct? . . . A. (Perusing) This letter reads that, yes. Q. Thank you. And you see no ambiguity whatsoever in that statement, do you? A. No, I don't.").

[316] Letter from Jackie Oliver (EMC Mortgage Corporation Senior Vice President, Chief Servicing Counsel) to XL Capital Assurance, Inc., dated June 4, 2008, EMC-SYN 000002859-2914; Letter from Alison Malkin (J.P. Morgan Securities Inc. Executive Director, Securitized Products) to XL Capital Assurance, Inc., dated August 4, 2008, EMC-SYN 00620317-343.

[317] *See Syncora Guarantee, Inc. v. EMC Mortg. Corp.*, No. 09-CV-3106 (PAC) (S.D.N.Y.). Two other monoline insurers have filed suit against EMC for substantially similar grounds. *See CIFG Assurance North America, Inc. v. EMC Mortg. Corp.*, No. 2009-30395-211 (Tex. Dist. Denton County); *Assured Guaranty Corp. v. EMC Mortg. Corp.*, No. 10-CV-5367 (S.D.N.Y.). In addition, the Federal Home Loan Bank of Seattle and the Federal Home Loan Bank of San Francisco recently brought actions against Bear, Stearns & Co., among others, alleging that it made numerous untrue statements or omissions of material facts in relation to securitization of loans. *See Federal Home Loan Bank of Seattle v. Bear, Stearns & Co., Inc.*, No. 10-CV-151 (RSM) (W.D. Wa. June 10, 2010); *Federal Home Loan Bank of San Francisco v. Credit Suisse Securities (USA) LLC, et. al.*, No. CGC 10-497839 (Cal. Super. Ct. June 10, 2010); *Federal Home Loan Bank of San Francisco v. Credit Suisse Securities (USA) LLC, et. al.*, No. CGC 10-497840 (Cal. Super. Ct. June 10, 2010).

[318] 9/25/2010 Lu Deposition Tr. at 10-11, 63-65, 131-38.

implemented a policy of conditioning repurchase determinations on whether JP Morgan had recourse to the loan seller.[319]

213. The conflicting and incompatible positions that JP Morgan asserted on EMC's behalf exemplifies JP Morgan's bad-faith strategy to reject legitimate repurchase demands by financial guarantors in order to mask any exposure to those claims on its financial statements – while at the same time keeping for itself any recoveries from the entities that originated and sold EMC the defective loans. JP Morgan employed these fraudulent and deceptive practices in order to tortiously interfere with and frustrate Ambac's contractual rights and remedies. JP Morgan did so without any regard for EMC's financial interest (which was severely compromises by the blatant contractual breaches).

214. JP Morgan's wholesale denial of the claims made by Ambac and other financial guarantors or private investors also is in stark contrast to the significantly higher approval rates for breaching loans identified by government-sponsored entities such as Fannie Mae and Freddie Mac. To avoid disqualification of the right to continue to do business with the government-sponsored entities, and with the weight of the federal government behind their demands, JP Morgan took markedly divergent positions with respect to the government-sponsored entities' loans than it did with respect to similar defects identified by Ambac.

215. As the extreme positions JP Morgan is taking to avoid EMC's repurchase obligations was being discovered, its reserving practices for repurchase obligations likewise have

[319] 9/25/2010 Lu Deposition Tr. at 131-38 ("Q. So to sum it up a little more clearly, Alison Malkin instructed Ashley Poole to add analysis of recourse to seller to the claims against analysis? (over objection) A. Based on this e-mail, yes. Q. Okay. And in turn Ms. Poole instructed you to fulfill that request, correct? A. Yes.").

also attracted the scrutiny of financial regulators.[320] In January 2010, the SEC issued a comment letter following an 8-K filing by JPMorgan Chase & Co. seeking substantial additional disclosures concerning its repurchase reserves. The SEC requested a detailed explanation as to how JP Morgan "establish[es] repurchase reserves for various representations and warranties . . . made to . . . GSE's, monoline insurers and any private loan purchasers," including "the specific methodology employed to estimate the allowance related to various representations and warranties, ***including any differences that may result depending on the type of counterparty to the contract***."[321] A full inquiry of JP Morgan's repurchase practices and policies necessarily will demonstrate its improper rejection of its repurchase obligations to manipulate its accounting reserves.

IV. BEAR STEARNS FRAUDULENTLY INDUCED AMBAC AND INVESTORS TO PARTICIPATE IN THE TRANSACTIONS

216. Bear Stearns knowingly and with the intent to induce reliance thereon made material misrepresentations to Ambac and investors and actively concealed material information pertaining to the specific Transactions at issue in this litigation.

217. These misrepresentations and omissions fraudulently induced Ambac to insure and investors to purchase the securities issued in the Transactions.

218. Ambac and the investors reasonably relied to their detriment on Bear Stearns' false and misleading representations and omissions made in the investor presentations and the Offering Documents. Ambac also reasonably relied to its detriment on Bear Stearns' false and

[320] Menal Mehta, *The SEC Just Demanded More Information on JPMorgan Repurchase Liabilities*, Bus. Insider, June 24, 2010, *available at* http://www.businessinsider.com/sec-jpmorgan-reserves-liabilities-2010-6.

[321] Letter from Amit Pande (SEC Accounting Branch Chief) to Michael J. Cavanaugh (JPMorgan Chase & Co. Chief Financial Officer) dated January 29, 2010 at pp. 1-2 (emphasis added), *available at* http://www.scribd.com/doc/33507476/SEC-Letter-to-JPM-Re-More-Disclosure-on-Buybacks-Jun-17-2010.

misleading representations and omissions in its other oral and written communications made *in advance of* each of the Transactions. Further, Bear Stearns' false and misleading representations and omissions pertaining to each Transaction fraudulently induced Ambac to enter into each successive Transaction.

219. As particularized in the preceding sections, Bear Stearns made false and misleading representations and omitted material information concerning, among other things, (i) its internal operations, including its seller approval, due diligence, quality control, and loan repurchase protocols, (ii) the actual due diligence purportedly conducted on the loans in the Transactions, (iii) the mortgage loan data Bear Stearns disseminated for each Transaction, (iv) the rating agencies' shadow ratings Bear Stearns secured for each Transaction, (iv) the historical performance of Bear Stearns' securitizations and mortgage loans, and (v) Bears Stearns' wherewithal and intent to stand behind the representations and warranties EMC made in the Transaction Documents.

220. Ambac's reasonable reliance on Bear Stearns' representations and omissions was contemporaneously documented in the memoranda Ambac prepared to obtain internal approval from its Credit Committee for each of the Transactions, each referred to as a "Credit Memorandum," and collectively, the "Credit Memoranda."[322] To start, the Credit Memorandum for each Transaction underscored the perceived significance of Bear Stearns as a counterparty, noting that "Bear, Stearns & Co. Inc. ('Bear Stearns' or 'Bear') has requested that Ambac

[322] Email from Patrick McCormick (Ambac First Vice President, MBS Department of Structured Finance) to Darryl Smith (Bear, Stearns & Co., Fixed Income Structured Credit Sales, Securitization Side), dated March 16, 2007, ABK-EMC01536345-346 ("Even though we BID on these deals, they have not been underwritten nor approved by our Credit Committee. As always, we are not committed on a deal, until it is approved by our Credit Committee . . . ."); Email from Darryl Smith (Bear, Stearns & Co., Fixed Income Structured Credit Sales, Securitization Side) to Patrick McCormick (Ambac First Vice President, MBS Department of Structured Finance), dated March 16, 2007, ABK-EMC02414491 (recommending that Ambac send an email to Bear traders reminding them that Ambac's "committee is more than just formality . . . that committee is still an important hurdle.").

insure" the Transactions.[323] The Credit Memoranda emphasized Ambac's reliance on Bear Stearns' reputation as an "[e]xperienced and established issuer with proven track record," and a "well established investment bank and issuer."[324] As the Credit Memoranda demonstrate, Bear Stearns leveraged its reputation to instill in Ambac false assurances regarding the historical performance of the SACO shelf,[325] and Bear Stearns' purported intent to stand behind the representations and warranties it gave through EMC regarding the veracity of the mortgage loan data and the underwriting practices used in making the loans.

221. Ambac specifically noted in its Credit Memoranda the significance of the fact that "EMC Mortgage Corporation as the sponsor of the transaction will provide Reps and Warranties on the loans, specifically they will guarantee that 'the information set forth in the Mortgage Loan Schedule hereto is true and correct in all material respects.'"[326] This commitment to attest to the *truth* of the mortgage loan data Bear Stearns provided was reproduced verbatim from the email sent by the Bear, Stearns & Co. Managing Director for United States Residential Mortgage Backed Securities Investor Relations to Ambac the day before the Credit Memorandum was submitted for the Transaction approval, showing the import of the representation.[327] Bear Stearns made the same representation to the rating agencies to secure the shadow (and final)

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[323] *See* SACO 2005-10 Credit Memorandum, dated December 16, 2005, § 2.1; SACO 2006-02 Credit Memorandum, dated January 13, 2006, § 2.1; SACO 2006-08 Credit Memorandum, dated August 10, 2006, § A.6; BSSLT 2007-1 Credit Memorandum, dated March 27, 2007, § A.6.

[324] *See, e.g.*, SACO 2005-10 Credit Memorandum, dated December 16, 2005, § 1; SACO 2006-02 Credit Memorandum, dated January 13, 2006, § 1.

[325] *See, e.g.*, SACO 2005-10 Credit Memorandum, dated December 16, 2005, § 2.22; SACO 2006-02 Credit Memorandum, dated January 13, 2006, § 2.22; BSSLT 2007-1 Credit Memorandum, dated March 27, 2007, § A.6.

[326] BSSLT 2007-1 Credit Memorandum, dated March 27, 2007, § E.

[327] *See* Email from Cheryl Glory (Bear, Stearns & Co. Managing Director, Mortgage Finance) to Ambac, dated March 26, 2007, EMC-AMB 001431663-664 ("we do provide a rep and warranty that 'the information set forth in the Mortgage Loan Schedule hereto is true and correct in a material respects.'").

ratings, without which Ambac would not have agreed to issue its policies (as evidenced by the reference to the ratings throughout the Credit Memoranda).

222. The Credit Memoranda could not be clearer, moreover, that Ambac relied on Bear Stearns' representations concerning the due diligence it purportedly conducted on the securitized loan pools: "There is no additional diligence done at the time of securitization as ***we rely on the EMC bulk and flow diligence process***."[328] And the Credit Memoranda explicitly reiterate Bear Stearns' representations that it conducted 100% due diligence on the loans in the Transactions: "The HELOCs have been sourced through Bears' bulk acquisition channel and are ***100% re-underwritten in terms of credit and legal compliance***."[329] What Ambac did not know was that Bear Stearns' representations were false and misleading, and in this regard, that Bear Stearns viewed its due diligence to be useless and a "waste of money."

223. The Credit Memorandum pertaining to the BSSLT Transaction also recites Bear Stearns' disclosures about the so-called benefits of improvements to its underwriting criteria and efforts to limit securitization from "terminated" or "suspended" loan originators and sellers.[330] Bear Stearns did not disclose that it was clearing out its inventory of loans that it had previously purchased from these entities while simultaneously discontinuing quality control over these very loans that it knew represented markedly greater risks, in what its own traders described as a "going out of business sale."[331]

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[328] *See, e.g.*, 2005-10 Credit Memorandum, dated December 16, 2005, § 10.14; 2006-02 Credit Memorandum, dated January 13, 2006, § 9.3.

[329] *See* 2006-08 Credit Memorandum, dated August 10, 2006, § A.6; BSSLT Credit Memorandum, dated March 27, 2007, § E.

[330] BSSLT 2007-1 (Group II and III) Credit Memorandum, dated April 13, 2007.

[331] *See* Section III.C.7, above.

224. Lacking the accurate depiction of Bear Stearns' practices and perspective, Ambac's reliance on Bear Stearns' representations and warranties was reasonable and consistent with the industry practice and the parties' bargain. As was the general practice and the parties' agreement, Bear Stearns and Ambac assumed risk and undertook due diligence consistent with their respective roles in the Transactions.

225. Bear Stearns as the sponsor and seller (through EMC), and as underwriter and deal manager (through Bear, Stearns & Co.), assumed the *risk* and the burden of assessing the validity of the attributes of the mortgage loans that it conveyed to the trusts, including that the loans were originated pursuant to the appropriate underwriting guidelines and were not fraudulently procured. Ambac as the insurer bore the *market risk* and the burden of evaluating whether loans *bearing the attributes represented by Bear, Stearns & Co. Inc. and warranted by EMC* would perform after the closing of the Transactions.

226. That was a reasoned risk allocation. Bear Stearns was in privity with – and often financed – the originators that sold to Bear Stearns the loans that it conveyed to the securitization trusts. Bear Stearns dictated the underwriting guidelines, owned the loans and held the loan files, which afforded it access and control over information required to evaluate the loans. To the extent Bear Stearns identified any defect in the loans, it had the right to exclude the loan from any transaction with the entity selling Bear Stearns the loans or demand that they repurchase the loans if the defects were discovered after purchase. Bear Stearns thus had the means before the closing of the Transaction to assess the quality of the loans and recourse in the event a defect was discovered. In contrast, Ambac was not in privity with the originators, never owned the loans or the loan files, and lacked recourse against the originators. It therefore made sense for the

sophisticated parties to agree that Bear Stearns would bear the loan origination risk, and Ambac would bear the market risk, assuming accurate disclosures by Bear Stearns.

227. This risk allocation arrangement enabled each party to conduct the appropriate due diligence *consistent and commensurate with* the risk each bore. Bear Stearns purported to carefully vet the originators from which it bought the loans, re-underwrite the loans before it purchased the loans, and conduct further review of the loans after acquisition.

228. Ambac, in turn, (i) conducted on-site reviews of Bear Stearns' operations, (ii) secured and evaluated Bear Stearns' representations concerning the seller approval, due diligence, quality control, and repurchase protocols Bear Stearns purportedly performed, (iii) conducted extensive modeling of its exposure to interest rate and other market variables using the mortgage loan data represented as true by Bear Stearns, (iv) assessed the adequacy of Bear Stearns' wherewithal to stand behind its representations and warranties, and (v) analyzed the represented performance of Bear Stearns' prior securitizations, and (vi) secured from Bear Stearns its commitment to provide, through EMC, representations and warranties concerning, among other things, the veracity of the mortgage loan data Bear Stearns provided and underwriting practices followed.

229. The representations and warranties that Bear Stearns provided through EMC, and on which Ambac relied, were the means by which the parties memorialized and effectuated the reasoned risk allocation, and therefore, were the essential inducement for Ambac to participate in the Transactions.[332]

[332] Consistently, when asked whether "EMC deemed it important to make representations and warranties in order to persuade the RMBS investors to purchase from Bear Stearns," Haggerty testified that "Bear Stearns was marketing the certificates. It was viewed as a positive that EMC was making the reps and warranties." 1/29/2010 Haggerty Rule 30(b)(6) Deposition Tr. at 131.

V. BEAR STEARNS' EXPRESS REPRESENTATIONS, WARRANTIES, AND CONTRACTUAL COVENANTS WERE A MATERIAL INDUCEMENT TO AMBAC TO PARTICIPATE IN THE TRANSACTIONS AND ISSUE ITS INSURANCE POLICIES

A. THE TRANSACTION DOCUMENTS

1. The SACO 2005-10 Transaction

230. As the Sponsor/Seller in the SACO 2005-10 Transaction, EMC, acting at all times at the direction and under the control of Bear, Stearns & Co. pooled and securitized approximately 13,172 residential mortgage loans, which EMC had previously purchased from numerous mortgage-loan originators, with an aggregate principal balance of approximately $626,731,100. These loans served as collateral for the issuance of more than $574 million in publicly offered mortgage-backed securities.[333]

231. The SACO 2005-10 Transaction closed on December 30, 2005 and was effectuated through the following series of agreements executed by EMC and its affiliates that governed, among other things, the rights and obligations of the various parties with respect to the mortgage loans and the securities that resulted from their securitization.

232. EMC, acting as Seller, sold and assigned its entire interest in the mortgage loans to its affiliate Bear Stearns Asset Backed Securities I LLC ("BSABS I") pursuant to a MLPA dated as of December 30, 2005 (the "SACO 2005-10 MLPA"). Under the SACO 2005-10 MLPA, EMC made numerous detailed representations and warranties concerning the mortgage loans.

233. BSABS I, in turn, sold its interest in the mortgage loans to the SACO I Trust 2005-10 (the "SACO 2005-10 Trust") pursuant to a Pooling and Servicing Agreement ("PSA") dated as of December 1, 2005 (the "SACO 2005-10 PSA"). The SACO 2005-10 Trust then

[333] Additional mortgage-backed securities issued in the SACO 2005-10 Transaction were not offered to the public.

issued various classes of mortgage-backed securities, the most senior of which were registered with the SEC and underwritten and marketed to investors by Bear, Stearns & Co. by means of the related Prospectus and ProSupp. In order to enhance the marketability of the securities and its return on the Transaction, EMC sought to obtain a financial-guaranty insurance policy from Ambac.

234. As an inducement to issue the policy, EMC entered into an I&I Agreement with Ambac, dated as of December 30, 2005 (the "SACO 2005-10 I&I Agreement"), whereby, among other things, EMC made numerous representations and warranties to Ambac with respect to the SACO 2005-10 Transaction, including that the representations and warranties that it had made in the SACO 2005-10 MLPA were true and correct in all material respects, and agreed to indemnify Ambac in the event that EMC's representations and warranties proved to be untrue. The other parties to the SACO 2005-10 I&I Agreement are BSABS I, the SACO 2005-10 Trust, LaSalle Bank National Association ("LaSalle"), as Master Servicer and Securities Administrator, and Citibank N.A. ("Citibank"), as Trustee.

235. Relying on Bear Stearns' pre-contractual representations detailed above and EMC's representations and warranties, covenants and indemnities contained in and encompassed by the SACO 2005-10 I&I Agreement, SACO 2005-10 MLPA, and SACO 2006-2 PSA, Ambac issued Certificate Guaranty Insurance Policy No. AB0961BE (the "SACO 2005-10 Policy"). Under the SACO 2005-10 Policy, Ambac agreed to insure certain payments of interest and principal with respect to the most senior, or investment-grade, classes of the securities issued in the SACO 2005-10 Transaction (the "SACO 2005-10 Insured Certificates"). The SACO 2005-10 Insured Certificates were underwritten and marketed, and sold to note purchasers ("SACO 2005-10 Note Purchasers"), by Bear, Stearns & Co.

2. The SACO 2006-2 Transaction

236. Shortly after securing the insurance policy for the SACO 2005-10 Transaction, EMC sought to have Ambac insure the SACO 2006-2 Transaction, which closed on January 30, 2006.

237. EMC, acting at all times at the direction and under the control of Bear, Stearns & Co., pooled approximately 13,261 mortgage loans, with an aggregate principal balance of approximately $704,481,804, that were secured by junior liens on one- to four-family residential properties. These loans in turn served as collateral for the issuance of more than $645 million in publicly offered mortgage-backed securities.[334] EMC had previously acquired these loans from numerous originators. The SACO 2006-2 Transaction was effectuated through the following series of agreements.

238. EMC, acting as Seller, sold and assigned its entire interest in the mortgage loans to BSABS I pursuant to a MLPA dated as of January 30, 2006 ("SACO 2006-2 MLPA"). BSABS I, in turn, sold its interest in the mortgage loans to the SACO I Trust 2006-2 (the "SACO 2006-2 Trust") pursuant to a PSA dated as of January 1, 2006 (the "SACO 2006-2 PSA").[335] The SACO 2006-2 Trust then issued various classes of mortgage-backed securities, the most senior of which were registered with the SEC and underwritten and marketed to investors by Bear, Stearns & Co. by means of the related Prospectus and ProSupp.

239. As in the case of the SACO 2005-10 Transaction, EMC, to induce Ambac to issue a financial-guaranty insurance policy, entered into an I&I Agreement with Ambac, dated as of January 30, 2006 (the "SACO 2006-2 I&I Agreement"), to which BSABS I, the SACO 2006-2

[334] Additional mortgage-backed securities issued in the SACO 2006-2 Transaction were not offered to the public.

[335] For convenience of reference, the SACO 2005-10 PSA and SACO 2006-2 PSA are hereinafter referred to collectively as the PSAs, and each individually as a PSA.

Trust, LaSalle, and Citibank are also parties, and the terms of which are virtually identical to those of the SACO 2005-10 I&I Agreement.

240. Relying on Bear Stearns' pre-contractual representations detailed above, EMC's representations and warranties, covenants and indemnities contained in and encompassed by the SACO 2006-2 I&I Agreement, SACO 2006-2 MLPA, and SACO 2006-2 PSA, and having recently received assurances from EMC regarding its due-diligence practices, Ambac issued Certificate Guaranty Insurance Policy No. AB0971BE and Certificate Guaranty Insurance Policy No. AB0972BE (collectively, the "SACO 2006-2 Policy"). Under the SACO 2006-2 Policy, Ambac agreed to insure certain payments of interest and principal with respect to the most senior, or investment-grade, classes of the securities issued in the SACO 2006-2 Transaction for the benefit of the holders of those securities (the "SACO 2006-2 Insured Certificates"). The SACO 2006-2 Insured Certificates were underwritten and marketed, and sold to note purchasers ("SACO 2006-2 Note Purchasers"), by Bear, Stearns & Co.

3. The SACO 2006-8 Transaction

241. A few months after securing the insurance policies for the SACO 2006-2 Transaction, Bear Stearns again marketed another of EMC's deals to investors and Ambac in connection with the SACO 2006-8 Transaction, which closed on September 15, 2006.

242. On September 15, 2006, in consummating the SACO 2006-8 Transaction, EMC pooled 5,282 HELOCs, with an aggregate principal balance of approximately $361,200,413, that were secured primarily by second-lien positions on one- to four-family residential properties. These loans in turn served as collateral for the issuance of approximately $356 million in publicly offered mortgage-backed securities.[336] In completing the SACO 2006-8 Transaction,

[336] Additional mortgage-backed securities issued in the SACO 2006-8 Transaction were not offered to the public.

EMC, acting at all times at the direction and under the control of Bear, Stearns & Co., securitized these HELOCs in much the same manner as it securitized the mortgage loans involved in the two previous deals.

243. EMC, acting as Seller, sold and assigned its entire interest in the Mortgage Loans to BSABS I pursuant to a MLPA dated as of September 15, 2006 (the "SACO 2006-8 MLPA"). BSABS I, in turn, sold its interest in the HELOCs to the SACO I Trust 2006-8 (the "SACO 2006-8 Trust") pursuant to a Sale and Servicing Agreement ("SSA") dated as of September 15, 2006 (the "SACO 2006-8 SSA").

244. As part of the 2006-8 Transaction, an Indenture dated as of September 15, 2006, was entered into by and among the SACO 2006-8 Trust, LaSalle, and Citibank, as Indenture Trustee, and provided for, among other things, the issuance of SACO I Trust 2006-8 Mortgage-Backed Notes, Series 2006-8 representing the indebtedness of the SACO 2006-8 Trust, the most senior of which were registered with the SEC and underwritten and marketed to investors by Bear, Stearns & Co. by means of the related Prospectus and ProSupp.

245. As an inducement to Ambac to issue its insurance policy, EMC, BSABS I, the SACO 2006-8 Trust, LaSalle, and Citibank entered into an I&I Agreement with Ambac, dated as of September 15, 2006 (the "SACO 2006-8 I&I Agreement"), whereby EMC made numerous representations and warranties and undertook certain obligations in consideration for Ambac's issuance of its insurance policy.[337] The SACO 2006-8 I&I Agreement contains substantially the same terms and conditions as the I&I Agreements in the two previous Transactions.

246. Relying on Bear Stearns' pre-contractual representations detailed above and EMC's representations and warranties, covenants, and indemnities contained in and

[337] *See* 2006-8 I&I Agreement at 2, fourth full recital.

encompassed by the SACO 2006-8 I&I Agreement, SACO 2006-8 MLPA, and SACO 2006-8 SSA, Ambac issued Certificate Guaranty Insurance Policy No. AB1020BE (the "SACO 2006-8 Policy"). Under the SACO 2006-8 Policy, Ambac agreed to insure certain interest and principal payments with respect to, and for the benefit of the holders of, the most senior, or investment-grade, class of securities issued in the SACO 2006-8 Transaction (the "SACO 2006-8 Insured Notes"). The SACO 2006-8 Insured Notes were underwritten and marketed, and sold to note purchasers ("SACO 2006-8 Note Purchasers"), by Bear, Stearns & Co.

4. The BSSLT 2007-1 Transaction

247. Finally, not long after securing an insurance policy for the SACO 2006-8 Transaction, Bear Stearns sought to obtain an insurance policy from Ambac for the BSSLT 2007-1 Transaction, which closed on April 30, 2007.

248. In effectuating the BSSLT 2007-1 Transaction, EMC, acting at all times at the direction and under the control of Bear, Stearns & Co., pooled approximately 5,173 HELOCs, with an aggregate principal balance of approximately $351,881,948, that were secured primarily by second-lien positions on residential properties. These loans in turn served as collateral for the issuance of more than $348 million in publicly offered mortgage-backed securities ("Group I Notes").[338] In addition, EMC, acting at all times at the direction and under the control of Bear, Stearns & Co., pooled approximately 12,621 conventional mortgage loans, with an aggregate principal balance of approximately $838,903,950, that were secured by second-lien mortgages on single-family homes. These loans in turn served as collateral for the issuance of $776,623,000 in publicly offered mortgage-backed securities ("Group II and III Notes"). The BSSLT 2007-1 Transaction was effectuated through the following series of agreements.

[338] Additional mortgage-backed securities issued in the BSSLT 2007-1 Transaction were not offered to the public.

249. EMC, acting as Seller, sold and assigned its entire interest in the Group I HELOCs, Group II Mortgage Loans, and Group III Mortgage Loans to its affiliate BSABS I pursuant to a MLPA dated as of April 30, 2007 (the "BSSLT 2007-1 MLPA").[339] BSABS I, in turn, sold its interest in the Group I HELOCs, Group II Mortgage Loans, and Group III Mortgage Loans to the BSSLT 2007-1 Trust (the "BSSLT 2007-1 Trust")[340] pursuant to a SSA dated as of April 30, 2007 (the "BSSLT 2007-1 SSA").[341]

250. As part of the BSSLT 2007-1 Transaction, an Indenture dated as of April 30, 2007 was entered into by and among the BSSLT 2007-1 Trust, LaSalle, and Citibank, as Indenture Trustee, and provided for, among other things, the issuance of BSSLT Trust 2007-1 Mortgage-Backed Notes, Series 2007-1 representing the indebtedness of the BSSLT 2007-1 Trust, the most senior of which were registered with the SEC and underwritten and marketed to investors by Bear, Stearns & Co. by means of the related Prospectus and ProSupp.

251. As in the case of each of the three prior Transactions, as an inducement to Ambac to issue its insurance policy, EMC, BSABS I, the BSSLT 2007-1 Trust, LaSalle, and Citibank entered into an I&I Agreement with Ambac, dated as of April 30, 2007 (the "BSSLT 2007-1 I&I Agreement"),[342] the terms of which are substantially the same as the I&I Agreements in the prior three Transactions.

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[339] For convenience of reference, the SACO 2005-10 MLPA, SACO 2006-2 MLPA, SACO 2006-8 MLPA, and BSSLT 2007-1 MLPA are hereinafter referred to collectively as the MLPAs, and each individually as an MLPA.

[340] For convenience of reference, the SACO 2005-10 Trust, SACO 2006-2 Trust, SACO 2006-8 Trust, and BSSLT 2007-1 Trust are hereinafter referred to collectively as the Trusts, and each individually as a Trust.

[341] For convenience of reference, the SACO 2006-8 SSA and BSSLT 2007-1 SSA are hereinafter referred to collectively as the SSAs, and each individually as an SSA.

[342] For convenience of reference, the SACO 2005-10 I&I Agreement, SACO 2006-2 I&I Agreement, SACO 2006-8 I&I Agreement, and BSSLT 2007-1 I&I Agreement are hereinafter referred to collectively as the I&I Agreements, and each individually as an I&I Agreement.

252. Relying on Bear Stearns' pre-contractual representations detailed above and EMC's representations and warranties, covenants and indemnities contained in and encompassed by the BSSLT 2007-1 I&I Agreement, Ambac issued the Certificate Guaranty Insurance Policy No. AB1075BE (the "BSSLT 2007-1 Policy").[343] Under the BSSLT 2007-1 Policy, Ambac agreed to insure certain payments of interest and principal with respect to, and for the benefit of, the holders of the most senior classes of Notes issued in the BSSLT 2007-1 Transaction (the "BSSLT 2007-1 Insured Notes").[344] The BSSLT 2007-1 Insured Notes were underwritten and marketed, and sold to note purchasers ("BSSLT 2007-1 Note Purchasers"), by Bear, Stearns & Co.[345]

B. EMC'S EXPRESS REPRESENTATIONS AND WARRANTIES THAT EFFECTUATED THE PARTIES' BARGAINED-FOR RISK ALLOCATION

253. Under the Transaction Documents, the principal and interest payments from the loans[346] were to provide the cash flow necessary to make the monthly principal and interest payments due on the Notes. Ambac's insurance policies required it to make payments to insured Note Purchasers to the extent there was a shortfall of cash flow available from the loans, once the protection provided by subordinated classes of securities and other credit enhancement was eroded. Ambac agreed to assume this risk of payment default, which depended upon the truth of the information Bear Stearns provided to Ambac regarding the pedigree of the securitized loans

[343] For convenience of reference, the SACO 2005-10 Policy, SACO 2006-2 Policy, SACO 2006-8 Policy, and BSSLT 2007-1 Policy are hereinafter referred to collectively as the Policies, and each individually as a Policy.

[344] For convenience of reference, the SACO 2005-10 Insured Certificates, SACO 2006-2 Insured Certificates, SACO 2006-8 Insured Notes, and BSSLT 2007-1 Insured Notes are hereinafter referred to collectively as the Notes.

[345] For convenience of reference, the SACO 2005-10 Note Purchasers, SACO 2006-2 Note Purchasers, SACO 2006-8 Note Purchasers, and BSSLT 2007-1 Note Purchasers are hereinafter referred to collectively as the Note Purchasers.

[346] For convenience of reference, the HELOCs and conventional mortgage loans, as the case may be, involved in these four Transactions are hereinafter referred to simply as the "loans."

and Bear Stearns' purportedly thorough due diligence practices. Consequently, from the perspective of the Note Purchasers (or the Insurer standing in their shoes), the key provisions of the deal documents were those that allocated to EMC the risk of loss due to misrepresentations, fraud or other failures that EMC was in the position to control.

1. Loan-Level Representations and Warranties

254. The provisions of the principal Transaction Documents that allocated to EMC such risk of loss are EMC's representations and warranties regarding, among other things, the origination (including underwriting) and other key attributes of the loans, and are found in Section 7 of the respective MLPAs.

255. Among its extensive representations and warranties in the SACO 2005-10 and SACO 2006-2 Transactions, EMC represented and warranted as to each mortgage loan that:

> MLPA § 7(a): "The information set forth in the Mortgage Loan Schedule on the Closing Date is complete, true and correct."
>
> MLPA § 7(h): "Each loan at the time it was made complied in all material respects with applicable local, state and federal laws, including but not limited to, all applicable anti-predatory lending laws."
>
> MLPA § 7(q): ". . . [I]mmediately prior to the Cut-off Date, there was no default, breach, violation or event of acceleration existing under the Mortgage or the Mortgage Note and there was no event which, with the passage of time or with notice and the expiration of any grace or cure period, would constitute a default, breach, violation or event of acceleration, and the related Mortgage Loan Seller has not waived any default, breach, violation or event of acceleration."
>
> MLPA § 7(s): "At the time of origination, each Mortgaged Property was the subject of an appraisal which conformed to the underwriting requirements of the originator of the Mortgage Loan, and the appraisal is in a form acceptable to Fannie Mae or Freddie Mac."
>
> MLPA § 7(t): "The origination, servicing and collection practices with respect to each Mortgage Note and Mortgage including, the

> establishment, maintenance and servicing of the escrow accounts and escrow payments, if any, since origination, have been conducted in all respects in accordance with the terms of Mortgage Note and in compliance with all applicable laws and regulations and, unless otherwise required by law or Fannie Mae/Freddie Mac standards, in accordance with proper, prudent and customary practices in the mortgage origination and servicing business . . . ."
>
> MLPA § 7(dd): "Each Mortgage Loan at the time of origination was underwritten in general in accordance with guidelines not inconsistent with the guidelines set forth in the Prospectus Supplement and generally accepted credit underwriting guidelines."
>
> MLPA § 7(ee): "No error, omission, misrepresentation, fraud or similar occurrence with respect to a Mortgage Loan has taken place on the part of either Mortgage Loan Seller or the related Originator."

256. In addition to representations and warranties that are virtually identical to those referenced above, EMC also made the following additional representations and warranties with respect to the loans contained in the SACO 2006-8 Transaction:

> MLPA § 7(d): "No HELOC had a Combined Loan to Value Ratio at the time of origination of more than 100%."
>
> MLPA § 7(j): " . . . No fraud, error, omission, misrepresentation, gross negligence or similar occurrence with respect to a HELOC has taken place on the part of any Person, including without limitation, the Mortgagor, any appraiser, any builder or developer, or any other party involved in the origination or servicing of the HELOC."

257. Finally, in the BSSLT 2007-1 Transaction, EMC represented and warranted as to each loan that:

> MLPA § 7(a): "[T]he information set forth in the Mortgage Loan Schedule hereto is true and correct in all material respects."
>
> MLPA § 7(c): "[E]ach Mortgage Loan at the time it was made complied in all material respects with all applicable local, state and federal laws and regulations, including, without limitation, usury, equal credit opportunity, disclosure and recording laws and all applicable predatory, abusive and fair lending laws; and each

> Mortgage Loan has been serviced in all material respects in accordance with all applicable local, state and federal laws and regulations, including, without limitation, usury, equal credit opportunity, disclosure and recording laws and all applicable anti-predatory lending laws and the terms of the related Mortgage Note, the Mortgage and other loan documents."
>
> MLPA § 7(d): "[T]here is no monetary default existing under any Mortgage or the related Mortgage Note and there is no material event which, with the passage of time or with notice and the expiration of any grace or cure period, would constitute a default, breach or event of acceleration; and neither the Seller, any of its affiliates nor any servicer of any related Mortgage Loan has taken any action to waive any default, breach or event of acceleration . . . ."
>
> MLPA § 7(n): "[A]t the time of origination, each Mortgaged Property was the subject of an appraisal which conformed to the underwriting requirements of the originator of the Mortgage Loan and, the appraisal is in a form acceptable to Fannie Mae or FHLMC."
>
> MLPA § 7(r): "[T]he information set forth in Schedule A of the Prospectus Supplement with respect to the Mortgage Loans is true and correct in all material respects."
>
> MLPA § 7(t): "[E]ach Mortgage Loan was originated in accordance with the underwriting guidelines of the related originator."

258. As demonstrated by their number, scope, and particularity, the foregoing representations and warranties were designed to convey absolute confidence that EMC was standing behind the quality of the loans and, specifically, accepting the risk of loss should any of the loans be found to have been included in the Transactions in violation of any representation or warranty.

2. Transactional-Level Representations and Warranties

259. EMC induced Ambac to issue the Policies by, among other things, extending to Ambac the representations and warranties that EMC had made in the MLPAs, PSAs, and SSAs, providing even broader representations and warranties in the I&I Agreements, and affording

Ambac even greater remedies for breaches of EMC's representations and warranties than those that EMC had extended to the Trusts and Note Purchasers in the Transaction Documents. These additional representations and remedies were consistent with Ambac's central role in the Transactions as the ultimate backstop for payments due to the Note Purchasers. EMC's numerous representations and warranties to Ambac, and the broad remedies afforded for their breach, conveyed EMC's blanket commitment that the loans that EMC had sold to the Trusts conformed to EMC's representations and warranties and were not tainted by fraud, error, omission, misrepresentation, negligence, or similar occurrence in their origination or underwriting. In providing this commitment, Bear Stearns assured Ambac that EMC would bear the risk of loss in the event that any of its representations and warranties proved inaccurate.

260. EMC's broad representations and warranties, and its commitment to bear the risk of their inaccuracy, are clearly and unambiguously stated in the I&I Agreements. First, the I&I Agreements explicitly extend to Ambac the numerous representations and warranties that EMC made in the MLPAs:

> I&I Agreement § 2.04(1): *Company Documents*. The representations and warranties of the Seller [EMC] contained in the Company Documents[347] to which it is a party are true and correct in all material respects and the Seller [EMC] hereby makes each such representation and warranty to, and for the benefit of, the Insurer [Ambac] as if the same were set forth in full herein.[348]

261. Second, the I&I Agreements provide that Ambac is a third-party beneficiary of the other principal Transaction Documents, with all rights afforded thereunder, including the representations, warranties, and covenants that EMC made in the key Transaction Documents:

[347] The I&I Agreements for all of the Transactions define "Company Documents" to include, among other things, the I&I, the MLPA, and the SSA or PSA, as applicable.

[348] The language in Section 2.04(l) is identical in each of the I&I Agreements.

> I&I Agreement § 2.05(j): *Third-Party Beneficiary*. The Seller [EMC] agrees that the Insurer [Ambac] shall have all rights of a third-party beneficiary in respect of the Company Documents and hereby incorporates and restates its representations, warranties and covenants as set forth therein for the benefit of the Insurer.[349]

262. Third, the I&I Agreement for each Transaction adds for Ambac's benefit new representations and warranties not found in the underlying Transaction Documents, including EMC's promise as to the truthfulness of the information it provided to Ambac about each of the Transactions:

> I&I Agreement § 2.04(j): *Accuracy of Information.* No information supplied by the Seller [EMC] contained in the Company Documents to which it is a party nor other material information relating to the operations of the Seller or the financial condition of the Seller, as amended, supplemented or superseded, furnished to the Insurer in writing or in electronic format by the Seller contains any statement of material fact which was untrue or misleading in any material respect when made. The Seller does not have any knowledge of any circumstances that could reasonably be expected to cause a Material Adverse Change with respect to the Seller. Since the furnishing of the Company Documents, there has been no change nor any development or event involving a prospective change known to the Seller that would render any of the Company Documents untrue or misleading in any material respect.[350]

> I&I Agreement § 2.04 (k): *Compliance with Securities Laws. . . .* The Company Information[351] in the Offering Documents[352]do not contain any untrue statement of a material fact and do not omit to state a material fact necessary to make the statements made therein, in light of the circumstances under which they were made, not misleading . . . .[353]

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[349] SACO 2006-8 I&I Agreement § 2.05(j). Section 2.05(j) of the I&I Agreements for the other Transactions includes virtually identical language.

[350] The language in Section 2.04(j) is identical in each of the I&I Agreements for all the Transactions.

[351] The I&I Agreements for all of the Transactions define "Company Information" as "all information with respect to the Offering Documents other than the Insurer Information and the Underwriter Information."

[352] The I&I Agreements in all of the Transactions define "Offering Documents" to include the Free Writing Prospectus, the Prospectus Supplement, the Base Prospectus, and any document with respect to

263. EMC's warranty to Ambac in Section 2.04(k) of the I&I Agreements are significant. As discussed in detail above, the Offering Documents contained disclosures pertaining to the loan characteristics, the underwriting and due diligence conducted, and the risks associated with an investment in the Notes. In making this representation about the Offering Documents, which was material and incremental to the representations and warranties made in the MLPAs, EMC sought to provide further comfort to Ambac about the accuracy and completeness of the total mix of information about the Transactions made available by EMC. In so doing, EMC again assumed the risk that the disclosures misstated or omitted material facts. In fact, as previously discussed, this representation and warranty was breached because the Offering Documents contained false and misleading information about key loan metrics on a pool-wide basis, and the underwriting and due diligence performed on the loans, and contained material omissions because they failed to disclose the abysmal origination, underwriting and due-diligence practices and procedures that account for the incredible incidence of fraud and gross underwriting failings plaguing these loans.

C. EMC'S CONTRACTUAL COVENANTS REINFORCING THE PARTIES' BARGAINED-FOR RISK ALLOCATION

1. EMC's Promise to Give Prompt Notice of Breaches

264. To reinforce the parties' bargained-for risk allocation and further assure the deal participants that the loans complied with its representations and warranties, the MLPAs provide ongoing obligations on all securitization participants to promptly disclose any loan found to have been included in the Transactions in violation of any of EMC's myriad loan-level representations and warranties.

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the insured notes or certificates (as the case may be) that makes reference to the policies approved by Ambac.

[353] The language in Section 2.04(k) is identical in each of the I&I Agreements.

265. Specifically, Section 7 of the MLPA for the SACO 2006-8 Transaction[354] provides, in pertinent part, as follows:

> Upon discovery or receipt of notice by the HELOC Seller [EMC], the Purchaser [a Bear Stearns affiliate], the Issuer, the Note Insurer [Ambac] or the Indenture Trustee of a breach of any representation or warranty of the HELOC Seller set forth in this Section 7 which materially and adversely affects the value of the interests of the Purchaser, the Issuer, the Note Insurer, the Noteholders or the Indenture Trustee in any of the HELOCs . . . or which adversely affects the interests of the Note Insurer, the party discovering or receiving notice of such breach shall give prompt written notice to the others.

266. Section 7 of the MLPAs for the SACO 2005-10 and SACO 2006-2 Transactions similarly provides, in pertinent part, as follows:

> Upon discovery or receipt of notice by the Sponsor [EMC], the Certificate Insurer [Ambac], the Purchaser [a Bear Stearns affiliate] or the Trustee of a breach of any representation or warranty of the Sponsor set forth in this Section 7 which materially and adversely affects the value of the interests of the Purchaser, the Certificateholders, the Certificate Insurer or the Trustee in any of the Mortgage Loans . . . the party discovering or receiving notice of such breach shall give prompt written notice to the others.

267. The PSAs and SSAs relating to the Transactions, as applicable, contain corresponding and virtually identical notification provisions.[355]

268. The notification provisions are absolute; they are in no way conditioned on EMC's ability to pursue claims against the originators of those loans or ultimately cure the defects affecting the breaching loans. Instead, they are designed to give prompt notice to the Transactions' participants of any breaching loan to ensure that EMC – and not Ambac, the Transactions, or its investors – bear the risk of loss associated with defective loans that EMC should not have securitized.

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[354] Section 7 of the BSSLT 2007-1 MLPA includes a substantially identical provision.

[355] *See, e.g.*, PSA § 2.03 for the SACO 2005-10 and SACO 2006-2 Transactions.

269. EMC's promise to promptly notify other Transaction participants of breaching loans subsequently found to have been included in the Transactions was also a material inducement of Ambac's and investors' participation in the Transactions.

2. EMC's Promise to Repurchase or Cure Breaching Loans Within 90 Days

270. Disclosing the existence of breaching loans identified in the Transactions was necessary and essential to enforcing EMC's express contractual obligation to repurchase those loans or cure the breach in a timely manner (*i.e.*, 90 days) – and, thus, minimize the risk of loss to the Transactions' investors and insurer in the event Bear Stearns securitized defective loans by allocating those risks squarely to EMC.

271. To carry out this bargained-for risk allocation, and to convey absolute confidence that EMC was standing behind the quality of the securitized loans, EMC agreed in the MLPAs that, should any of its loan-level representations and warranties prove untrue, it would cure the breach(es) or remove the breaching loan(s) from the pool. To this end, immediately following the notification obligations described above, Section 7 of the MLPA for the SACO 2006-8 Transaction[356] provides, in pertinent part, as follows:

> In the case of any such breach of a representation or warranty set forth in this Section 7, within 90 days from the date of discovery by [EMC], or the date [EMC] is notified by the party discovering or receiving notice of such breach (whichever occurs earlier), [EMC] will (i) cure such breach in all material respects, (ii) purchase the affected HELOC at the applicable Purchase Price, or (iii) if within two years of the Closing Date, substitute a qualifying Substitute HELOC in exchange for such HELOC.

[356] Section 7 of the MLPAs entered into in the three other Transactions include substantially identical provisions.

272. The PSAs and SSAs relating to the Transactions, as applicable, contain corresponding and virtually identical remedial provisions.[357]

273. While EMC's cure, repurchase, or substitution obligation (the "Repurchase Protocol") was a critical Transaction feature and a material inducement for Ambac to insure the Transactions, the parties intended this remedy to address the inadvertent inclusion in the Transactions by EMC of the aberrant non-complying loan. Because these provisions do not adequately address or compensate Ambac for the enormous harm inflicted by Bear Stearns' fraud or the wholesale failures to comply with the express representations and warranties that EMC made in the Transaction Documents, the Repurchase Protocol is inadequate and was not intended in such circumstances. EMC thwarted the intent of the parties embodied in their contractual agreements by selling to the Trusts predominantly non-compliant loans and pervasively breaching its representations and warranties by misrepresenting material facts and omitting material information. Further compounding the harm, EMC, under the direction of Bear, Stearns & Co. and subsequently JP Morgan executives, has essentially made a mockery of the Repurchase Protocol by refusing to repurchase all but a negligible number of defective loans submitted to it by Ambac.

D. THE BROAD LEGAL AND EQUITABLE REMEDIES RESERVED AND AFFORDED TO AMBAC UNDER THE TRANSACTION DOCUMENTS

1. Ambac's Express Right to Pursue Any and All Remedies at "Law or Equity"

274. The parties understood that the Repurchase Protocol would not fully address the quantum of risk and harm borne by Ambac in the event of wholesale misrepresentation of facts material to its risk assessment. Accordingly, while other parties to the Transactions may be

[357] *See* PSAs § 2.03.

limited to the remedies set forth in the MLPA and SSA or PSA, as applicable, Ambac is not. Section 5.02 of the I&I Agreements provides that any and all remedies at law and in equity – including those available in the Company Documents – are available to Ambac on a non-exclusive and cumulative basis.

275. Pursuant to Section 5.02(a) of the I&I Agreements, EMC agreed that upon the occurrence of an "Event of Default,"[358] which event includes EMC's breaches of the loan-level representations and warranties in the MLPA, Ambac may

> take whatever action at law or in equity as may appear necessary or desirable in its judgment to collect the amounts, if any, then due under this Insurance Agreement . . . or to enforce performance and observance of any obligation, agreement or covenant of . . . [EMC] under Company Documents.

Section 5.02(b) of the I&I Agreements further provides that any and all remedies at law and in equity – including those available in the Company Documents – are available to Ambac on a non-exclusive and cumulative basis.[359]

276. Pursuant to Section 5.03(a) of the I&I Agreements, EMC expressly agreed that "[t]he exercise by [Ambac] of any right hereunder shall not preclude the exercise of any other right, and the remedies provided herein to [Ambac] are declared in every case to be cumulative and not exclusive of any remedies provided by law or equity."[360]

[358] An "Event of Default" is defined under Section 5.01(a) of the I&I Agreements as occurring when, among other things, "[a]ny representation or warranty made by the Depositor, the Issuing Entity, the Master Servicer or the Seller hereunder or under the Company Documents, or in any certificate furnished hereunder or under the Company Documents, shall prove to be untrue or incomplete in any material respect."

[359] The language in Section 5.02 is identical in each of the I&I Agreements.

[360] The language in Section 5.03 is identical in each of the I&I Agreements.

2. Ambac's Contractual Rights to Indemnification and Reimbursement

277. Pursuant to Section 3.04 of the I&I Agreements, EMC also agreed to pay and indemnify Ambac for any and all losses, claims, demands, damages, costs, or expenses by reason of, among other things,

> the negligence, bad faith, willful misconduct, misfeasance, malfeasance or theft committed by any director, officer, employee or agent of the . . . Seller [EMC] in connection with any Transaction arising from or relating to the Company Documents;
>
> the breach by the . . . Seller [EMC] of any representation, warranty or covenant under any of the Company Documents . . . ; or
>
> any untrue statement or alleged untrue statement of a material fact contained in any Offering Document or any omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein, in light of the circumstances under which they were made, not misleading . . . ."[361]

278. In Section 3.03(b) of the I&I Agreements, EMC further agreed to reimburse Ambac for "any and all charges, fees, costs and expenses that the Insurer may reasonably pay or incur, including reasonable attorneys' and accountants' fees and expenses ("Reimbursable Expenses") in connection with . . . the enforcement, defense or preservation of any rights in respect of any of the Company Documents . . . ."[362]

VI. EMC'S PERVASIVE BREACHES OF ITS REPRESENTATIONS AND WARRANTIES

A. AMBAC'S LOAN-LEVEL REVIEW UNCOVERED PERVASIVE BREACHES

279. A loan-level review and analysis undertaken by Ambac's independent consultants (at enormous effort and expense) has revealed that a significant number loans in the Transactions

[361] The language in Section 3.04(a) is identical in each of the I&I Agreements.

[362] The language in Section 3.03(b) is identical in each of the I&I Agreements.

breach one or more of EMC's extensive loan-level representations and warranties pertaining to the underwriting of the loans and the key loan metrics for each Transaction.

280. To date, Ambac, through its independent consultant, has reviewed a total of 6,309 loans across the Transactions. The results of Ambac's loan-level analyses revealed that at least 5,724 loans breached one or more of EMC's representations and warranties, evidencing a staggering 90% breach rate. These loans contain one or, in most cases, more than one defect that constitute a breach of one or more of the numerous representations and warranties made by EMC in the applicable MLPA and materially altered the loans' risk profile. These defects include:

- rampant fraud, primarily involving misrepresentation of the borrower's income, assets, employment, or intent to occupy the property as the borrower's residence (rather than as an investment), and subsequent failure to so occupy the property;
- failure by the borrower to accurately disclose his or her liabilities, including multiple other mortgage loans taken out to purchase additional investment property;
- inflated and fraudulent appraisals; and,
- pervasive violations of the loan originators' own underwriting guidelines and prudent mortgage-lending practices, including loans made to borrowers (i) who made unreasonable claims as to their income, (ii) with multiple, unverified social-security numbers, (iii) with debt-to-income and loan-to-value ratios above the allowed maximums, or (v) with relationships to the applicable originator or other non-arm's-length relationships.

281. Each of these breaches adversely affected Ambac's interests, or materially and adversely affected the value of Ambac's interests in the identified loan. Loans subject to fraud, that were not originated and underwritten pursuant to prudent and proper practices, or the key attributes of which are otherwise misrepresented are markedly more risky and therefore less valuable than loans not suffering from such shortcomings.

282. In addition to the non-performing loans, Ambac randomly selected 1,562 loans from the Transactions, of which 1,492 loans were available to review, thereby constituting a

statistically sound representative sample of the loans in the Transaction. The randomly selected loans from each Transaction included both defaulted loans and loans still current in payments (as well as loans that had already paid in full at the time of Ambac's review). The results of this randomly-generated sample were shocking, and demonstrate with a high degree of certainty that breaches of representations and warranties exist in a comparable percentage of loans *in the total loan pool* in each Transaction.

- Of the sample of 377 randomly selected loans in the SACO 2005-10 Transaction, Ambac identified breaches of representations and warranties in 340 loans, or 90%.

- Of the sample of 378 randomly selected loans in the SACO 2006-2 Transaction, Ambac identified breaches of representations and warranties in 347 loans, or 92%.

- Of the sample of 366 randomly selected loans in the SACO 2006-8 Transaction, Ambac identified breaches of representations and warranties in 338 loans, or 92%.

- Of the sample of 361 randomly selected loans in the BSSLT 2007-1 Transaction, Ambac identified breaches of representations and warranties in 325 loans, or 90%.

283. Pursuant to Section 7 of the MLPAs, through a series several letters between on April 25, 2008 and June 17, 2010, Ambac promptly gave formal notice to EMC and the other deal participants identifying the breaching loans found to have been included in the Transactions, and describing such breach, or breaches, affecting those loans with specificity. Upon receipt of such notices, EMC became obligated under the applicable MLPAs and PSAs/SSAs to repurchase or cure the affected loans within 90 days. Ambac's notices further reserved any and all rights to assert additional claims or demands including with respect to indemnification, reimbursement, breaches, or other claims.

284. JP Morgan – acting with authority to perform EMC's obligations under the Transaction Documents – responded to Ambac's breach notices between July 2008 and

November 2010 agreeing to repurchase ***only 52 loans, or less than 1%, of the 5,724 of breaching loans*** that Ambac identified. EMC, at the behest of its new management under JP Morgan, refused to repurchase any of the remaining loans or acknowledge the breaches in what amounts to a deliberate and bad faith frustration of the repurchase protocol further compounding the massive harm inflicted by Bear Stearns on Ambac and the Transactions' investors. And, despite EMC's assurances and follow-up requests by Ambac, EMC has failed even to repurchase those loans that it committed to repurchase, demonstrating its blatant and bad-faith disregard of its contractual obligations and representations.[363]

285. By its wholesale rejection of Ambac's repurchase demands, JP Morgan has thus made clear that it has no intention of allowing EMC to honor its contractual obligations. In its detailed responses to Ambac's breach notices, JP Morgan has taken positions in order to fraudulently reduce reserves that are wholly contrary to the express and unambiguous requirements of the applicable underwriting guidelines that EMC represented were adhered to, EMC's other representations and warranties, its contractual covenants contained in the Transaction Documents and, perhaps most shockingly, ***the findings made and conclusions reached by Bear Stearns' own post-acquisition quality control department – findings that are memorialized in repurchase demands made by EMC and JP Morgan to the sellers of these same loans***.

[363] Bear Stearns did not respond to Ambac's letters requesting prompt repurchase of the loans that Bear Stearns agreed were in breach and represented would be repurchased. *See* Letter from Ambac to EMC, dated September 16, 2009, ABK-EMC02664451-454 (SACO 2005-10), ABK-EMC02664443-446 (SACO 2006-2), ABK-EMC02664439-442 (SACO 2006-8), and ABK-EMC02664447-450 (BSSLT 2007-1).

B. BEAR STEARNS' INTERNAL DOCUMENTS AND ADMISSIONS CONTRADICT ITS REJECTION NOTICES TO AMBAC AND REVEAL BEAR STEARNS' BAD FAITH

286. Consistent with Bear Stearns' operational abuses discussed above, EMC and JP Morgan regularly asserted and resolved repurchase claims against the entities from which it acquired securitized loans based on material and adverse defects affecting the loans at issue in the Transactions.[364]

287. Internal databases and documentation reflecting these claims activities and the quality control findings made on the mortgage loans constitute significant admissions as to pervasive defects in securitized loan pools due to, among other things, rampant misrepresentations or fraud concerning borrowers' ability to repay their debts, and abject underwriting failures that violate proper and prudent mortgage-lending practices, including the actual underwriting guidelines that were supposed to be used to originate the loans.

288. The internal databases available to and used by Bear Stearns (and then JP Morgan) irrefutably show the defects observed in a large number of the loans at issue in the Transactions and establish Bear Stearns' deliberate misrepresentation of its due diligence and quality control operations while marketing the Transactions and selling the Notes at issue in this case. In spite of, or potentially because of, the pertinent information contained in such databases, EMC initially refused to disclose them. For example, Bear Stearns' internal databases show, among other things, the status of securitized loans subject to claims activity and reveal that Bear Stearns (i) filed a "Problem Loan Worksheet" – which its internal policy documents require to be "created by the QC auditors as loans are reviewed, for those loans with breaches of reps and

[364] *See* Section III.F, above.

warrants, fraud, compliance issues, or misrepresentation"[365] – with respect to at least 2,900 loans, and (ii) filed formal claims against sellers due to EPD violations or other substantive defects on almost 4,000 loans. Similarly, Bear Stearns has made partial disclosures of its internal quality control data, including "Quality Control Management Summaries" and "Loan Review Detail Reports," indicating several hundred loans EMC deemed to be "Defective" and the reasons supporting that determination.

289. Although the defects conclusively establish breaches of EMC's representations and warranties given to Ambac and other securitization participants, in its deliberate bid to conceal the quality of the loans, Bear Stearns did not disclose these breaches upon discovery, which constitutes a separate breach of EMC's express obligation to provide "prompt" notice of its discovery of breaching loans.

290. Moreover, when Ambac uncovered the same defects that Bear Stearns' quality control and claims departments had previously and independently identified, JP Morgan deliberately and in bad faith directed EMC to reject Ambac's claims for its own illegitimate purposes, including JP Morgan's attempts to obtain recoveries from EMC's suppliers based on the same breaches raised by Ambac for those loans.

C. AMBAC'S DISCOVERY OF BORROWERS AND OTHER THIRD PARTIES VALIDATES THE BREACHES IDENTIFIED IN ITS REPURCHASE NOTICES

291. Documents subpoenaed by Ambac and its deposition examinations of many of the borrowers confirm Ambac's initial findings that the mortgage loan pools securitized by Bear Stearns in the Transactions are replete with fraud, misrepresentations, and violations of underwriting guidelines. Following are just some of the examples pertaining to loans that (i)

[365] EMC Conduit Manual, Chapter 10 Quality Control Process, dated October 1, 2004, EMC-AMB 004413698-735 at 700.

Bear Stearns securitized in the SACO 2006-8 Transaction, (ii) Ambac reviewed as part of its random sample, and (ii) JP Morgan continues to bar EMC from repurchasing despite Ambac's breach notices:

- ***EMC Loan Number [redacted]:*** This second-lien loan, with a principal balance of $52,000, was made to a borrower in Palm Coast, Florida for the purchase of a property valued at $260,000. The borrower also obtained a first-lien loan in the amount of $208,000. The borrower's loan application stated that he lived in Monterrey, California, earned $11,500 per month as a manager for the Sherwin Williams Company, had over $7,200 in his bank account, and was purchasing the house in Florida as a second home. Ambac found, among other things, that the loan application misrepresented the borrower's income because an affidavit the borrower filed with his bankruptcy petition in 2007 indicates his average monthly income in 2005 to be approximately $4,300 per month and in 2006 to be $5,715 per month. Ambac also found that the loan application misrepresented the borrower's employment, and its breach notice advised Bear Stearns of these findings and the representations and warranties breached as a result thereof. At a deposition on March 27, 2010, the borrower confirmed these findings and also testified that at the time of closing he had approximately $3,100 in his bank account, and not $7,200 as listed on the loan application. The borrower also testified that he was told at the closing that he had only fifteen minutes to sign all the paperwork, which had already been prepared and dated. The borrower complained, stating that he wanted to review the paperwork overnight, but was told by the mortgage broker that if he did not sign everything in fifteen minutes, "the loan was gone and the house was gone." Further, prior to the closing, the borrower had told the mortgage broker via telephone that he wanted a single, adjustable rate mortgage. The borrower discovered for the first time on his own at the closing that he was taking out two loans instead of one. He was still unaware that the second loan was an "interest only" HELOC which had an initial annual percentage rate of 6.50%. This rate was only applicable for the first three months, at which time it would reset to an adjustable rate mortgage with an annual percentage rate of prime plus 5%. The borrower discovered for the first time that the HELOC was an "interest only" loan when the three month teaser rate expired and his payments on the HELOC almost doubled.

- ***EMC Loan Number [redacted]:*** This second-lien loan with a principal balance of $67,000 was made to two ministers (borrower and co-borrower) for the purchase of a property valued at $337,000 in Henderson, Nevada. The couple's loan application indicated the borrower's income to be $11,850 per month as an ad developer for Heath and Associates advertising, Inc. in San Luis Obispo, California and the co-borrower's income as $5,950 per month as a teacher in San Luis Obispo for the State of California. The loan closed as a "primary residence" – *i.e.*, the borrowers were required to occupy the property as their primary residence. Ambac found, among other things, that the couple's stated income was

not reasonable, that the couple never occupied the property after closing, and that the loan application did not disclose that the couple had purchased another house in Nevada and had also refinanced their home in Arroyo Grande, California. Ambac advised Bear Stearns of these findings and the representations and warranties breached as result thereof. Deposition examinations of the couple not only corroborated these findings, but also revealed that the borrower was *unemployed* at the time of closing and *never worked for Heath and Associates Advertising*. The deposition also revealed that EMC had notice that the borrowers never occupied the property in Henderson because, immediately upon closing, it began sending the monthly mortgage statement to the borrowers' primary residence in California. In fact, when the borrowers could no longer pay their monthly mortgage payments, they contacted EMC and stated that they needed a deferment because the house in Henderson was a rental which had been vacant for a number of month. In contravention of the parties' agreement, EMC failed to notify Ambac of this breach, and then when notified by Ambac of this and other misrepresentations, refused to repurchase the loan.

- ***EMC Loan Number*** [redacted]***:*** This loan, with a principal balance of $57,000, was made to a borrower in East Bethel, Minnesota for the purchase of a property valued at $385,000. The borrower also obtained a first-lien loan with a balance of $304,000. The borrower's loan application indicated her income to be $10,500 per month and identified her employment as a national visual merchandise coordinator for Kohl's Department Stores. Ambac found that the borrower was employed in a local capacity, which would make her stated income of $10,500 not reasonable. Ambac advised Bear Stearns of these findings and the representations and warranties breached as result thereof. During the March 21, 2010 deposition, the borrower corroborated these findings. She testified that she has never held a national position at Kohl's and at the time of closing earned approximately $2,700 per month.

- ***EMC Loan Number*** [redacted]***:*** This second-lien HELOC in the amount of $104,000 was made to a borrower for the purchase of a property with the purchase price of $520,000. The loan application stated that borrower was employed as a general manager at Foto Mart, paid $2,500 per month in rent, and had almost $13,000 in her bank account – factors which suggest that the borrower had the ability to pay approximately $4,400 per month in housing expenses for the new property. Ambac found that the underwriter demonstrated negligence or misconduct in not verifying the large increase in the borrower's bank balance immediately prior to closing in light of the fact that her average account balance over the past three months was $518. Further, the borrower's credit report did not support her employment as a manager and her average bank balance of $518 did not support an earning potential from a management position. Ambac advised Bear Stearns of these findings and the representations and warranties breached as result thereof. The borrower testified at a deposition on November 19, 2009 that she earned approximately $2,270 per month as a babysitter and has never worked at Foto Mart. The borrower's loan file contained a verification of employment indicating that a loan underwriter called "Jorge," a manager at Foto Mart, and

> confirmed that the borrower was employed there as a general manager. The borrower testified that Jorge was actually her mortgage broker. The deposition also revealed that the borrower paid approximately $600 per month in rent prior to purchasing the property, and not $2,500 as indicated on the loan application. The borrower testified that twelve cancelled checks which purport to verify that she paid $2,500 per month in rent were forged: She did not sign these checks and the handwriting is someone else's.

292. For all of these loans, EMC represented and warranted, among other things, that (i) they complied in all material respects with applicable local, state and federal laws, including but not limited to, all applicable anti-predatory lending laws; (ii) at the time of closing, there was no default, breach, violation or event of acceleration existing under the Mortgages or Mortgage Notes (which the underlying loan documentation specifically states that a material misrepresentation in connection with obtaining the loan constitutes in a default); (iii) that the origination and servicing practices with respect to these loans have been conducted in all respects in accordance with the terms of the Mortgage Note and in compliance with all applicable laws and regulations and, unless otherwise required by law or Fannie Mae/Freddie Mac standards, in accordance with proper, prudent and customary practices in the mortgage origination and servicing business; and (iv) no fraud, error, omission, misrepresentation, gross negligence or similar occurrence with respect to these loans has taken place on the part of any Person, including without limitation, the Mortgagors, or any other party involved in the origination or servicing of these loans.

VII. HARM SUFFERED BY AMBAC AND NOTE PURCHASERS

293. The Transactions that Bear Stearns marketed and effectuated based on its materially false and misleading representations and disclosures have failed miserably. An overwhelming percentage of the loans that Bear Stearns securitized in each of the Transactions either have been written off as total losses or are severely delinquent causing massive shortfalls in the cash-flows of principal and interest needed to pay down the securities. As a result, the

Note Purchasers have incurred severe losses that have been passed on to Ambac as the financial guarantor.

294. The Transactions have experienced cumulative losses of more than $1.3 billion in the aggregate as of December 31, 2010. A significant portion of the loans in each Transaction are severely delinquent or charged-off, measured either by number or by loan balance (as reflected in the following table):

Transaction	**Cumulative Losses**	**% of Loans Severely Delinquent or Charged-Off (by Loan Balance)**
SACO 2005-10	$123.6 million	39.32%
SACO 2006-2	$279.5 million	42.43%
SACO 2006-8	$140.8 million	41.35%
BSSLT 2007-1	$800.8 million	67.67%

295. The severe losses realized by the Transactions have resulted in Ambac having to make claim payments to insured Note Purchasers. As reflected in the following table, as of December 31, 2010, Ambac has paid, or is obligated to pay, claims of more than $768.2 million in the aggregate.

Transaction	**Claims**	**Date of Ambac's First Claim Payment**
SACO 2005-10	$37.9 million	October 2008
SACO 2006-2	$109.7 million	April 2008
SACO 2006-8	$115.0 million	September 2007
BSSLT 2007-1	$505.6 million	July 2008

296. But for Ambac's coverage obligations to fund the shortfalls under the Policies, the Note Purchasers would have been deprived of the principal and interest payments. Subject to the

terms of the Policies, Ambac guaranteed to make payments for the benefit of the Note Purchasers in the event that cash flows received by the trusts became insufficient to pay down the Notes.[366]

297. Due to the high rate of expected defaults, future claims payments by Ambac are inevitable. Therefore, in addition to the substantial claims payments already made by Ambac under the Policies, Ambac has been forced to set aside hundreds of millions of dollars in reserves based on the expectation of future shortfalls affecting the Transactions.

298. As discussed above, the pervasive breaches of EMC's representations and warranties, revealed by the loan-file reviews and Bear Stearns' internal documents, and supported by the dismal loan performance in all four of the Transactions, pierce the very heart of the bargain struck by the parties. As has only recently become clear, EMC did not sell to the Trusts the contemplated portfolio of loans with the represented attributes. Rather, Bear Stearns transferred pools where the overwhelming majority of loans did not bear any resemblance to the loans EMC represented and warranted would comprise the pools. In doing so, Bear Stearns induced Ambac into insuring each successive Transaction based upon materially false and misleading information about that Transaction *and* the ones preceding it.

299. Contrary to EMC's representations and warranties in Section 2.04(k) of the I&I Agreements, the Offering Documents that Bear Stearns prepared to market the Notes that Ambac

[366] In contrast with other types of insurer-insured relationships, in a securitization transaction a monoline insurer such as Ambac generally does not have access to information relating to the identity of the insureds, *i.e.*, the Note Purchasers. Instead, Ambac makes payments to the trusts set up for each Securitization, which, in turn, makes the payment to the Note Purchasers. Further, because Bear Stearns – not Ambac – marketed and sold the Notes to the Note Purchasers upon closing of each Transaction, Bear Stearns and EMC know the identity of the Note Purchasers, which they have withheld from Ambac. By document requests dated March 3, 2010, Ambac demanded that EMC provide Ambac with "Documents sufficient to identify the name, address, phone number and email address as to any investor or purchaser of the securities issued in connection with any of the Transactions." Ambac made clear that this information was needed for it to prosecute this action, conduct discovery, and exercise its rights under the Transaction Documents. EMC refused to comply, and after a motion to compel by Ambac, has recently been ordered to produce communications with those investors.

insured (and the same documents that it filed with the SEC) contained material misrepresentations and omissions because they did not adequately or accurately disclose the true attributes of the loans (*e.g.*, the weighted average combined loan-to-value ratio, occupancy status, or debt-to-income ratio), the level of fraud and underwriting failings permeating the EMC loan pools, the grossly deficient origination practices of the originators of these loans, EMC's dismal due-diligence practices, the duplicitous role of its quality control department, or its scheme to recover from originators and pocket substantial sums of money that rightfully belonged to the securitization Trusts (*i.e.*, Ambac and the investors). Ambac would never have issued its Policies or agreed to participate in the Transactions had it known the true facts

300. Having pervasively and systematically breached its representations and warranties and wholly eviscerated the Repurchase Protocol, EMC has materially breached each of the I&I Agreements as a whole, which breaches entitle Ambac to be (i) returned to the position it would have been in had it not entered into the I&I Agreements and issued its Policies and (ii) compensated for the incremental harm incurred as a result of its participation in each of the Transactions.

301. At the very least, this relief requires the payment to Plaintiff by Bear Stearns of all claim payments made to date and all future claim payments required to be made under the respective Policies.

VIII. JPMORGAN CHASE & CO. HAS STRIPPED EMC OF ITS ASSETS, SEEKING TO RENDER EMC A JUDGMENT-PROOF SHELL, BUT SUBJECTING JPMC BANK TO SUCCESSOR LIABILITY

302. Subsequent to the filing of the original Complaint in this action detailing EMC's liability for the extensive losses suffered by Ambac, JP Morgan Chase & Co. has taken steps to strip EMC of its assets and render it unable to satisfy any judgment against it. In violation of EMC's numerous contractual obligations to Ambac, on or about April 1, 2011, JPMorgan Chase

& Co. effectuated an intercompany asset sale whereby EMC transferred to its affiliate, JPMC Bank, all of EMC's servicing-related assets (the "Asset Transfer"). (The mortgage servicing business entails processing payments from borrowers for securitized mortgages, such as those included in the Transactions, and distributing the proceeds to the Trusts, as well as pursuing delinquent borrowers and bringing foreclosure actions.) The transferred servicing assets include servicing rights on the four Transactions at issue in this litigation, several other Ambac-insured securitizations, as well as dozens of other securitizations. The servicing operations EMC sold to JPMC Bank constituted substantially all of EMC's assets and its last remaining operating assets. EMC has been shorn of its assets and has become, in essence, a shell. By taking these improper actions, JPMorgan Chase & Co. has subjected its subsidiary, JPMC Bank, to liability as EMC's successor.

A. EMC'S PAST SERVICING OPERATIONS

303. EMC acted as a servicer in connection with all four Transactions at issue in this litigation. At the time of the Transactions, servicing was one of EMC's several business operations, and one that Bear Stearns featured prominently in its discussions with Ambac. As explained above, EMC also specialized in the acquisition, securitization and disposition of mortgage loans. But by the time of the Asset Transfer in early 2011, JPMorgan Chase & Co. had shut down EMC's mortgage loan acquisition and securitization operations. Servicing was EMC's last remaining business operation, and its servicing business constituted EMC's last remaining substantial asset.

B. EMC'S COVENANTS NOT TO TRANSFER ITS ASSETS OR ITS SERVICING RIGHTS WITHOUT AMBAC'S CONSENT

304. Pursuant to the terms of express negative covenants in the I&I Agreements governing the Transactions, EMC agreed, among other things, not to merge with any person,

transfer substantially all of its assets, or interfere with the enforcement of any rights of Ambac. Specifically, pursuant to Section 2.06 of the I&I Agreements, EMC gave express covenants not to take certain actions "unless [Ambac] shall otherwise expressly consent in writing."[367] Among other things, EMC covenanted:

> Limitation on Mergers, Etc. ***[EMC] shall not*** consolidate with or ***merge with or into any Person or transfer all or substantially all of its assets*** to any Person or liquidate or dissolve except as provided in the Company Documents to which it is a party or as permitted hereby. ***[EMC] shall furnish to [Ambac] all information*** relating to it ***requested*** by [Ambac] that is reasonably necessary to determine compliance with this paragraph.[368]
>
> Impairment of Rights. ***[EMC] shall not take any action***, or fail to take any action, ***if such action or failure to take action may result in a Material Adverse Change*** specified in clause (ii) of the definition of Material Adverse Change with respect to [EMC], ***or may interfere with the enforcement of any rights of [Ambac]*** under or with respect to any of the Company Documents. [EMC] shall give [Ambac] written notice of any such action or failure to act by it on the earlier of: (i) the date upon which any publicly available filing or release is made with respect to such action or failure to act or (ii) promptly prior to the date of consummation of such action or failure to act. ***[EMC] shall furnish to [Ambac] all information requested*** by it that is reasonably necessary to determine compliance with this paragraph.[369]

305. "Material Adverse Change," for purposes of Section 2.06(a) of the I&I Agreements, is defined as "a material adverse change in . . . the ability of [EMC] to perform its obligations, if any, under any of the Company Documents."[370]

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[367] The language in Section 2.06 is identical in each of the I&I Agreements.

[368] SACO 2006-8 I&I Agreement § 2.06(c) (emphasis added). The language in Section 2.06(c) is identical in each of the I&I Agreements.

[369] SACO 2006-8 I&I Agreement § 2.06(a) (emphasis added). The language in Section 2.06(a) is identical in each of the I&I Agreements.

[370] SACO 2006-8 I&I Agreement § 1.01. The language in Section 1.01 is identical in each of the I&I Agreements.

306. EMC similarly committed not to transfer its servicing rights in the Transactions without Ambac's consent. Under the PSAs or SSAs governing the Transactions, a "Company Default" is caused when, among other things, "[EMC] attempts to assign its right to servicing compensation hereunder or ***[EMC] attempts to sell or otherwise dispose of all or substantially all of its property or assets or to assign this Agreement or the servicing responsibilities hereunder*** . . . ."[371] A Company Default by EMC can be waived only "***with the consent of [Ambac]*** . . . ."[372]

307. These restrictions on EMC's ability to merge, liquidate, or transfer all or substantially all of its assets generally, as well as on its ability to transfer the servicing rights in the Transactions, were critical contractual protections for Ambac. Ambac required assurances that its counterparty in the Transactions had the continuing financial wherewithal to stand behind the critical obligation, explained above, to cure or repurchase defective loans in the Transactions, reimburse Ambac and provide the indemnities required by its agreements with Ambac. In addition, given the important role of the mortgage servicer in ensuring that borrowers adhered to their payment obligations and recovering against those that did not – so that the loans contributed the expected revenues to the Trusts – Ambac also insisted upon a level of control over which party filled that role.

[371] SACO 2006-8 SSA § 7.05(vi). *See also* SACO 2005-10 PSA § 9.05(vi); SACO 2006-2 PSA § 9.05(vi); BSSLT 2007-1 SSA § 7.05(vi).

[372] SACO 2006-8 SSA § 7.06. *See also* SACO 2005-10 PSA § 9.06; SACO 2006-2 PSA § 9.06; BSSLT 2007-1 SSA § 7.06.

C. EMC BREACHED ITS COVENANTS NOT TO MERGE OR TRANSFER SUBSTANTIALLY ALL OF ITS ASSETS

308. JPMorgan Chase & Co., however, ignored these contractual obligations, and completed the Asset Transfer that stripped EMC of its sole remaining operating asset despite Ambac's express and repeated objections to the transfer.

309. On April 30, 2009, EMC first requested Ambac's consent for a planned transfer of servicing assets to JPMC Bank. In requesting Ambac's consent, EMC acknowledged that Ambac's consent to a transfer of EMC's servicing assets was required by contracts governing the Transactions.

310. Following EMC's request for Ambac's consent to the proposed transfer of servicing assets to JPMC Bank, Ambac made various informational requests to EMC in order to ascertain the fairness of consideration, and otherwise fully evaluate the proposed transaction and EMC's compliance with its contractual obligations. EMC did not comply with Ambac's requests. EMC refused to provide basic information to Ambac, such as (i) the agreement or agreements setting forth the complete terms of the transfer, and (ii) financial information reflecting the expected assets and liabilities of EMC immediately following the asset transfer. Ambac sought this information because, as the recipient of EMC's representations and warranties relating to billions of dollars of mortgage loans deposited into numerous securitization trusts insured by Ambac and repurchase obligations relating thereto, Ambac was entitled to assure itself that the valuable, income-producing assets were not being transferred for inadequate consideration. In view of EMC's continued refusal to provide basic information to Ambac regarding the consideration to be received by EMC and the financial condition of EMC post-transfer, Ambac refused to grant its consent for the proposed transfer of servicing assets by letter dated May 28, 2009.

311. In October 2010, nearly a year and a half after first raising the issue, counsel for EMC informed Ambac of its renewed intention to transfer EMC's servicing assets to JPMC Bank.

312. Ambac received a written request for consent dated November 12, 2010. Ambac once again requested information necessary to evaluate the proposed transaction and whether to provide the requested consent, such as information reflecting: whether EMC would receive fair consideration in exchange for the servicing assets; whether EMC was insolvent or would be rendered insolvent by the transfer; and whether the Asset Transfer would "interfere with the enforcement of any rights of [Ambac] under or with respect to any of the Company Documents."[373] For example, Ambac again requested the agreement or agreements setting forth the complete terms of the transfer. In addition, Ambac requested any third-party valuations to assess whether EMC was receiving fair value for the servicing assets.

313. During discussions from December 2010 through March 2011 with counsel for JPMorgan Chase & Co., Ambac repeatedly reiterated its need for such information in order to evaluate the request. Ambac also repeatedly reiterated that it could not, and would not, consent to the request without this critical information.

314. Once again, and in violation of the I&I Agreements, EMC and JP Morgan Chase & Co. withheld information necessary for Ambac to evaluate the proposed asset transfer and EMC's compliance with its obligations. Specifically, JPMorgan Chase & Co. refused to provide on EMC's behalf the agreement or agreements setting forth the complete terms of the transfer and any third-party valuations being relied upon to determine the purchase price. Accordingly, Ambac refused to grant its consent to the proposed Asset Transfer.

[373] SACO 2006-8 I&I Agreement 2.06(a). The language in Section 2.06(a) is identical in each of the I&I Agreements.

315. On April 4, 2011, counsel for JPMorgan Chase & Co. advised Ambac that the Asset Transfer had been completed on April 1, 2011, despite Ambac's refusal to provide its consent. As a result, EMC is in breach of the I&I Agreements, PSAs and SSAs governing the Transactions.

316. On June 3, 2011, counsel for Ambac notified EMC, *inter alia*, that EMC breached each of the I&I Agreements and the PSA/SSAs governing the Transactions by completing the Asset Transfer without the required consent of Ambac, and demanded that EMC remedy the breaches within 30 days. EMC refused to remedy its breaches.

317. Ambac has been greatly harmed by EMC's breaches of contract in effectuating the Asset Transfer without Ambac's required consent. Among other harms, as a consequence of the Asset Transfer, EMC has been stripped of its business operations and left as a shell without the wherewithal to satisfy its ongoing contractual obligations to Ambac in the Transactions.

D. AMBAC'S CONTRACTUAL RIGHTS TO SUE ANY SUCCESSOR OF EMC

318. In addition to breaching EMC's contractual obligations, the Asset Transfer has resulted in JPMC Bank becoming liable to Ambac for all obligations of EMC, including the repurchase of all breaching loans, as EMC's successor under the Successor and Assigns provisions of each of the MLPAs governing the Transactions:

> ***Any person into which [EMC] may be merged or consolidated*** (or any person resulting from any merger or consolidation involving [EMC]), any person resulting from a change in form of [EMC] or ***any person succeeding to the business of [EMC], shall be considered the "successor" of [EMC]*** hereunder and shall be considered a party hereto without the execution or filing of any paper or any further act or consent on the part of any party hereto. . . .[374]

[374] SACO 2006-8 MLPA § 23 (emphasis added). *See also* SACO 2005-10 MLPA § 24; SACO 2006-2 MLPA § 24; BSSLT 2007-1 MLPA § 23.

319. The Pooling and Servicing Agreements governing the SACO 2005-10 and SACO 2006-2 Transactions similarly provide:

> ***Any Person into which . . . [EMC] . . . may be merged or consolidated***, or any corporation resulting from any merger or consolidation to which . . . [EMC] . . . shall be a party, or ***any Person succeeding to the business of . . . [EMC] . . . , shall be the successor of . . . [EMC] . . . hereunder***, without the execution or filing of any paper or further act on the part of any of the parties hereto, anything herein to the contrary notwithstanding.[375]

320. Section 4.04 of the I&I Agreements provides that the I&I Agreements "shall be binding upon and inure to the benefit of the parties hereto and their respective successors and permitted assigns."[376]

321. Because the servicing business was EMC's sole remaining ongoing operating business, when JPMC Bank succeeded to that business through the Asset Transfer, it succeeded to EMC's obligations in the Transactions pursuant to the plain terms of the Transaction Documents.

E. JPMORGAN CHASE & CO. EFFECTUATED A DE FACTO MERGER OF EMC AND JPMC BANK

322. In addition to becoming EMC's successor by operation of these contractual provisions, the Asset Transfer orchestrated by the two entities' mutual parent company, JPMorgan Chase & Co, resulted in JPMC Bank becoming liable for all of the obligations and liabilities of EMC by operation of law. Ultimate ownership of the servicing operations that EMC transferred remain unchanged: both before and after the Asset Transfer, EMC and JPMC Bank

[375] SACO 2005-10 PSA § 8.02(b) (emphasis added). *See also* SACO 2006-2 PSA § 8.02(b). The SSAs governing the SACO 2006-8 and BSSLT 2007-1 deals do not contain equivalent provisions.

[376] SACO 2006-8 I&I Agreement § 4.04(a). The language in Section 4.04(a) is identical in each of the I&I Agreements.

were affiliates of the same banking family and ultimately owned by the same parent holding company, JPMorgan Chase & Co.

323. In addition, EMC has ceased independent business operations. EMC's website now describes EMC as "a brand of JPMorgan Chase Bank, N.A.,"[377] and states that "JPMorgan Chase Bank, N.A. services loans under the EMC Mortgage name."[378] EMC no longer services mortgages, and no longer engages in any other business operations.

324. JPMC Bank has assumed the obligations necessary for the uninterrupted continuation of the operations performed by EMC prior to the Asset Transfer. Specifically, JPMC Bank has assumed EMC's obligations to service mortgage loans under the contracts governing various RMBS deals, including the four Transactions at issue in this litigation.

325. JPMC Bank has retained EMC's management and personnel, as well as EMC's physical locations and, as noted, EMC's assets and general business operations. After the Asset Transfer, EMC's former management and personnel continue to handle the transferred servicing operations from the same business locations. EMC's former servicing operations located in Dallas, Texas − now belonging to JPMC Bank − are continuing to handle payment processing, borrower inquires and related functions.[379]

[377] EMC Mortgage® A Brand of JPMorgan Chase Bank, N.A., https://www.emcmortgagecorp.com/EMCMORTGAGE/ (last visited July 18, 2011).

[378] EMC Mortgage® A Brand of JPMorgan Chase Bank, N.A., About Us, https://www.emcmortgagecorp.com/EMCMORTGAGE/MainContent/about_us.jsp (last visited July 18, 2011).

[379] EMC Mortgage® A Brand of JPMorgan Chase Bank, N.A., Contact Us, https://www.emcmortgagecorp.com/EMCMORTGAGE/MainContent/contact_us.jsp (last visited July 18, 2011).

FIRST CAUSE OF ACTION

(Against Defendants JP Morgan and EMC for Fraudulent Inducement)

326. Plaintiff realleges and incorporates by reference paragraphs 1 through 325 of this Complaint.

327. As set forth above, Defendants JP Morgan (formerly Bear, Stearns & Co.) and EMC made materially false public statements, and omitted material facts, with the intent to defraud the public and Ambac.

328. Defendants made materially false statements and omitted material facts with the intent to defraud Ambac in pre-contractual communications between Ambac and Defendants' officers.

329. Defendants, knowingly and with the intent to defraud, delivered to Ambac materially false and misleading documentation, including investor presentations, loan tapes, and Offering Documents, and fraudulently-induced ratings by the rating agencies.

330. Ambac reasonably relied on Defendants' statements and omissions when it entered into the I&I Agreements and issued its Policies.

331. As a result of Defendants' statements and omissions, Ambac insured pools of loans that had a risk profile far higher than Defendants led Ambac to understand.

332. As a result of Defendants' false and misleading statements and omissions, Plaintiff has suffered, and will continue to suffer, damages.

333. Because Defendants committed these acts and omissions maliciously, wantonly, oppressively, and with knowledge that they would affect the general public – which they have – Plaintiff is entitled to punitive damages.

SECOND CAUSE OF ACTION

(Against Defendant EMC for Breaches of Representations and Warranties)

334. Plaintiff realleges and incorporates by reference paragraphs 1 through 333 of this Complaint.

335. The I&I Agreement in each Transaction is a valid and binding agreement between Ambac and EMC. In the I&I Agreements, EMC explicitly agreed to extend to Ambac the numerous representations and warranties that EMC made in the MLPAs.

336. Ambac has performed its obligations under the I&I Agreements.

337. EMC has materially breached its representations and warranties under Section 7 of the MLPAs and Section 2.04 of the I&I Agreements.

338. Plaintiff has been damaged and will continue to be damaged in an amount to be determined at trial.

THIRD CAUSE OF ACTION

(Against Defendant EMC for Breaches of Repurchase Obligation)

339. Plaintiff realleges and incorporates by reference paragraphs 1 through 338 of this Complaint.

340. EMC has materially breached its obligations under Section 7 of the MLPAs and Section 2.03 of the PSAs or SSAs, as applicable, by refusing to cure, repurchase, or provide substitutes for the loans that breached EMC's representations and warranties and with respect to which (i) EMC had discovered the breach or (ii) notice of breach has been provided by Ambac to EMC.

341. Plaintiff has been damaged and will continue to be damaged in an amount to be determined at trial.

FOURTH CAUSE OF ACTION

(Against Defendant JP Morgan for Tortious Interference with Contractual Relationship)

342. Plaintiff realleges and incorporates by reference paragraphs 1 through 341 of this Complaint.

343. Under Section 7 of the MLPAs and Section 2.03 of the PSAs or SSAs, as applicable, EMC is required to cure, repurchase, or provide substitutes for loans that breached EMC's representations and warranties.

344. Bear, Stearns & Co. at all relevant times had notice and knowledge of this contractual relationship between Ambac and EMC and of the contractual obligations referred to in Paragraph 316 above. After EMC and Bear, Stearns & Co. were acquired by JPMorgan Chase & Co., JP Morgan also had notice and knowledge of such contractual obligations.

345. As a direct and proximate result of JP Morgan's tortious interference, which is continuing, EMC breached such contractual obligations, and is continuing to do so.

346. JP Morgan's tortious interference was, and is, improper and without justification or privilege. JP Morgan's interference was not intended to, and did not, further the economic interest of EMC; and, as a mere affiliate of EMC, JP Morgan did not have its own economic interest in EMC which would be protected by EMC's breach of its contractual obligations to Ambac. Moreover, JP Morgan's interference was not intended to protect any purported economic interest it had in EMC; rather, it did so in order to assist its parent corporation, JP Morgan Chase, in effectuating a massive accounting fraud based on an unjustified and material understatement of reserves on its financial statements relating to the liability inherited from EMC for repurchase obligations associated with defective loans.

347. Moreover, JP Morgan effectuated its interference with EMC's contractual obligations to Ambac by fraudulently and deceptively representing to Ambac that the rejections of Ambac's repurchase demands were based on the reasons set forth in the written responses to those demands.

348. JP Morgan engaged in these actions through improper, fraudulent and deceptive means and with the conscious, willful, wrongful, tortious, illegal, and wanton intent to manipulate JPMorgan Chase & Co.'s required accounting disclosures and injure Ambac in its trade or business.

349. As a direct and proximate result of the conduct described herein, Plaintiff has been damaged, and continues to be damaged, in its trade or business. Plaintiff has suffered, and will continue to suffer, monetary loss that it would not have suffered but for JP Morgan's tortious conduct, and are threatened with continuous and irreparable damage and/or loss.

FIFTH CAUSE OF ACTION

(Against Defendant EMC for Material Breaches of Each of the I&I Agreements)

350. Plaintiff realleges and incorporates by reference paragraphs 1 through 349 of this Complaint.

351. EMC induced Ambac to enter into the I&I Agreements and to issue the Policies by making extensive representations and warranties concerning the loans that EMC caused to be sold to the Trusts, and by agreeing to broad remedies for breaches of those representations and warranties.

352. EMC's representations and warranties were material to Ambac's decision to insure each of the Transactions, and Ambac was induced thereby to enter into each I&I Agreement and perform its obligations thereunder.

353. EMC has materially breached the I&I Agreements, and the loan-by-loan cure-repurchase-or-substitution remedy is both inadequate to address the magnitude and pervasiveness of the breaches identified and is being frustrated by EMC's wholesale failure to comply with it.

354. Plaintiff has been damaged and will continue to be damaged in an amount to be determined at trial.

SIXTH CAUSE OF ACTION

(Against Defendant EMC for Indemnification)

355. Plaintiff realleges and incorporates by reference paragraphs 1 through 354 of this Complaint.

356. Pursuant to Section 3.04(a) of the I&I Agreements, Ambac is entitled to be indemnified for any and all claims, losses, liabilities, demands, damages, costs, or expenses of any nature arising out of or relating to the transactions contemplated by the Company Documents by reason of, among other things, (i) the negligence, bad faith, willful misconduct, misfeasance, malfeasance or theft committed by any director, officer, employee or agent of EMC, (ii) the breach by EMC of any of the representations, warranties, or covenants contained in the Company Documents, and (iii) any untrue statement or alleged untrue statement of material fact contained in any Offering Document or any omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein, in light of the circumstances under which they were made, not misleading.

357. By reason of the foregoing, EMC has caused Plaintiff to pay claims and incur losses, costs, and expenses, and will continue to cause Plaintiff to pay claims and incur losses, costs, and expenses.

SEVENTH CAUSE OF ACTION

(Against Defendant EMC for Breach of Contract − the Asset Transfer)

358. Plaintiff re-alleges and incorporates by reference paragraphs 1 through 357 of this Complaint.

359. EMC has consolidated with, merged into, or transferred all or substantially all of its assets to JPMC Bank without Ambac's express written consent, in violation of Section 2.06 of the I&I Agreements, and in violation of Section 9.05 of the SACO 2005-10 PSA, Section 9.05 of the SACO 2006-2 PSA, Section 7.05 of the SACO 2006-8 SSA, and Section 7.05 of the BSSLT 2007-1 SSA.

360. EMC failed to furnish to Ambac all information relating to the Asset Transfer requested by Ambac that was reasonably necessary for Ambac to determine EMC's compliance with Sections 2.06(a) and 2.06(c) of the I&I Agreements.

361. Before EMC and JPMC Bank consummated the Asset Transfer on or about April 1, 2011, Ambac made repeated requests to EMC for certain information that would allow Ambac to determine, among other things, whether the transfer would "interfere with the enforcement of any rights of [Ambac] under or with respect to any of the Company Documents."

362. EMC failed to provide Ambac with the requested information and consummated the Asset Transfer in breach of Section 2.06 of the I&I Agreements and without obtaining Ambac's consent. EMC's failure was without justification and was a breach of the I&I Agreements.

363. The Asset Transfer constitutes a Company Default by EMC under Section 7.05 of the SSAs or Section 9.05 of the PSAs governing the Transactions. Ambac's consent is required for there to be a waiver of EMC's default. Ambac has not provided the requisite consent. As a result, the Company Default is continuing.

364. As a result of EMC's breaches, Ambac has been and will continue to be damaged in an amount to be determined at trial.

365. In addition, by virtue of EMC's breach of the I&I Agreements, Ambac is entitled to specific performance of EMC's obligation to provide information relating to the Asset Transfer requested by Ambac.

EIGHTH CAUSE OF ACTION

(Against Defendant EMC for Attorneys' fees and costs)

366. Plaintiff realleges and incorporates by reference paragraphs 1 through 365 of this Complaint.

367. Pursuant to Section 3.03(b) of the I&I Agreements, EMC agreed to reimburse Ambac for any and all charges, fees, costs, and expenses paid or incurred in connection with, among other things, enforcing, defending, or preserving Ambac's rights under the Company Documents.

368. Plaintiff has incurred numerous expenses, including attorneys' fees and expert fees, in order to enforce, defend, and preserve its rights under the relevant agreements.

NINTH CAUSE OF ACTION

(Against Defendant JPMC Bank for Successor Liability)

369. Plaintiff re-alleges and incorporates by reference paragraphs 1 through 368 of this Complaint.

370. JPMC Bank is liable for any and all damages, reimbursement and indemnification amounts resulting from the wrongful actions of EMC, as alleged herein, because both contractually under the Transaction Documents and as a matter of law JPMC Bank is the

successor to EMC as a result of EMC's Asset Transfer to JPMC Bank on or about April 1, 2011, wherein JPMC Bank acquired all or substantially all of EMC's assets.

371. JPMC Bank is a person that has succeeded to the business of EMC. As a result, JPMC Bank is the successor to EMC under the MLPAs governing the Transactions and automatically became a party to the MLPAs in accordance with their terms. In addition, because JPMC Bank is a person that succeeded to the business of EMC, JPMC Bank is the successor to EMC under the PSAs governing the SACO 2005-10 Transaction and the SACO 2006-2 Transaction and automatically became a party thereto in accordance with their terms. Also because JPMC Bank is the successor to EMC, the I&I Agreements governing the Transactions are binding on JPMC Bank.

372. Additionally, JPMC Bank is the successor to all of the obligations and liabilities of EMC by operation of law as a consequence of the de facto merger of JPMC Bank and EMC resulting from the Asset Transfer.

373. After the Asset Transfer, there remains continuity of ownership of EMC and JPMC Bank. Both before and after the Asset Transfer, EMC and JPMC Bank were ultimately owned and controlled by the same parent holding company, JPMorgan Chase & Co.

374. EMC has ceased its ordinary business operations. After the Asset Transfer, JPMC Bank services loans under the EMC Mortgage Name.

375. JPMC Bank has assumed the liabilities necessary for the uninterrupted continuation of the operations performed by EMC prior to the Asset Transfer. Specifically, JPMC Bank has assumed EMC's obligations to service mortgage loans under the contracts governing various RMBS deals, including the four Transactions at issue in this litigation.

376. JPMC Bank has retained EMC's management and personnel, as well as EMC's physical locations, assets, and general business operations. After the Asset Transfer JPMC Bank has continued the servicing operations once belonging to EMC using EMC's employees, management and facilities.

PRAYER FOR RELIEF

WHEREFORE, Plaintiff respectfully prays for the following relief:

- For an award of all legal, equitable, and punitive damages, to be proven at trial, against Defendants for their fraudulent inducement of Ambac's participation in the Transactions and issuance of its Policies;
- For an award of compensatory, consequential, and/or rescissory damages, including all of Plaintiff's claims payments made and to be made in the future, and any other present and future damages to be proven at trial, for Defendants' willful, wanton, and malicious material breaches of its contracts with Ambac;
- For an order compelling EMC to comply with its obligations under MLPA § 7, SSA § 2.03, and PSA § 2.03, as applicable, in each Transaction to cure, repurchase, or substitute the loans that breach its representations and warranties;
- For an award of compensatory damages for EMC's material breach of its representations and warranties under MLPA § 7 and I&I Agreement § 2.04 in each Transaction and its obligation to cure, repurchase, or substitute the loans that breach its representations and warranties pursuant to the remedial provisions of MLPA § 7, SSA § 2.03, and PSA § 2.03, as applicable in each Transaction, in an amount to be proven at trial;
- For an order of indemnification for the claim payments and other losses and expenses Plaintiff has paid or will pay in the future pursuant to I&I Agreement § 3.04(a) in each Transaction;
- For an order awarding reimbursement of Plaintiff's attorneys' fees, and other costs and expenses incurred in enforcing, defending, or preserving their rights under the Transaction Documents pursuant to I&I Agreement § 3.03(b) in each Transaction;
- For an order of prejudgment interest;
- For an order requiring EMC to provide to Ambac all information requested regarding the Asset Transfer, which EMC is required by Section 2.06 of the I&I Agreements to provide;

- For an order holding JPMC Bank liable as EMC's successor to pay in full any award of damages in this case and any reimbursement or indemnification amounts for which EMC may be liable to Ambac; and

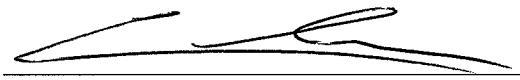
- For an Order awarding Plaintiff such other and further relief as the Court deems just and proper.

JURY DEMAND

Plaintiff demands a trial by jury for all issues so triable as a matter of right.

Dated: New York, New York
July 18, 2011

Respectfully Submitted,



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